

**ANALYSIS OF THE POLICIES, LAWS, REGULATIONS, AND
SUPERVISION PRACTICES AFFECTING THE ENVIRONMENT FOR
MICROFINANCE IN THE WEST BANK AND GAZA**

Submitted to:

**Chemonics International – Initiative for Sustainable and Accessible Microfinance
Industry (ISAMI) Project**

and

**The United States Agency for International Development (USAID) / West Bank and
Gaza Mission**

Submitted by:

**Stephanie Charitonenko
Project Manager
Chemonics International, Inc.**

February 2001

TABLE OF CONTENTS

List of Boxes, Figures, and Tables.....	ii
Preface.....	iii
Abbreviations and Acronyms.....	iv
Executive Summary.....	vi
1. Introduction.....	1
A. Objectives	
B. Analytical Framework	
C. Methodology	
D. Organization	
2. The Policy Environment.....	4
A. Recent Economic Performance and Key Socioeconomic Data	
B. Macroeconomic and Sectoral Policies	
3. The Legal Framework.....	10
A. Legal Forms and Regulation and Supervision	
B. Rules Governing Lending Activity and Collateral	
C. MSE Formation and Operation	
4. The Palestinian Small and Micro Finance Network.....	34
A. Establishment Objectives	
B. Potential Functions	
5. Conclusion.....	37
A. Main Findings and Recommendations	
B. Topics for Future Research	
Bibliography.....	44
Annexes.....	46
1: Scope of Work (SOW)	
2: List of Persons Consulted	

LIST OF BOXES, FIGURES, AND TABLES

Boxes

- Box 1.1: Explanation of the Financial Systems Paradigm
- Box 3.1: Common Adaptations of Traditional Bank Prudential Regulations and Supervision that Address the Specialized Operations of Most MFIs
- Box 3.2: The Creation of Private Financial Funds (FFPs) in Bolivia
- Box 3.3: Recent History of Land Registration and Titling in the WBGS
- Box 3.4: Operational Issues Involved in Land Registration and Titling in the WBGS

Figures

- Figure 3.1: The Palestinian Banking System
- Figure 3.2: Distribution of Credit Facilities by Economic Activity
- Figure 3.3: Comparative Rating of Regulatory and Administrative Constraints to Business
- Figure 3.4: Financing Issues in the Operation and Growth of WBGS Businesses
- Figure 3.5: Sources of Credit for WBGS Businesses

Tables

- Table 2.1: Selected Macroeconomic Indicators
- Table 2.2: Percentage Distribution of Labor Force Participants by Age and Sex
- Table 2.3: Key Socioeconomic Data, 2000 (est.)
- Table 3.1: Number and Total MSEs in the WBGS by Economic Activity
- Table 3.2: Microfinance Activities and Forms of Regulation
- Table 3.3: The Microfinance Market in Bolivia

PREFACE

This report was prepared as part of the “Initiative for a Sustainable and Accessible Microfinance Industry” (ISAMI) sponsored by USAID/West Bank and Gaza (USAID/WBG). It is primarily based on the draft study, “Review of Policy, Legal, and Regulatory Environment of Micro Finance in Palestine” prepared by Massar Associates in September 2001. Building on USAID/WBG’s technical assistance to the Palestine Monetary Authority under the ISAMI project, this report identifies constraints inhibiting the development of a microfinance industry and proposes improvements in the policy environment, the legal framework, and prudential regulation and supervision to create an enabling environment for the development of a sustainable microfinance industry.

The author acknowledges the invaluable insight and guidance provided by her colleagues at Chemonics – Jim Whitaker, Imad Hamze, Peter Bittner, Ron Ivey, and Anita Campion. In addition, sincere thanks goes to Lubna Katbeh of Massar Associates for her helpful explanations on subjects she raised in the earlier study as its lead author, and for the useful background references she provided. Also, all the representatives of banks, community development, financial institutions, consulting firms, and donor organizations (listed in Annex 2) who were generous in sharing their insights, relevant background documents, and time, are much appreciated. In spite of all these valuable contributions, this work is the responsibility of the author, and as such, any errors or omissions are strictly her own.

ABBREVIATIONS AND ACRONYMS

ACAD	Arab Center for Agricultural Development
ADR	Alternative Dispute Resolution
ANERA	American Near-East Refugee Aid
Ann.	Annual
Avg.	Average
BDS	Business Development Services
CGAP	Consultative Group to Assist the Poorest
CMA	Capital Markets Authority
CWEP	Center for Women's Economic Projects
EU	European Union
FATEN	Palestine for Credit and Development
FFP	Private Financial Funds (Fondos Financieros Privados)
GDP	Gross Domestic Product
GIE	Gaza Industrial Estate
GIS/LIS	Geographic Information System/Land Information System
GNI	Gross National Income
GNP	Gross National Product
GPS	Geographic Positioning System
GS	Gaza Strip
IAS	International Accounting Standards
IFC	International Finance Corporation
IMF	International Monetary Fund
IR	Intermediate Result
IRC	Information Registration Center
ISAMI	Initiative for a Sustainable and Accessible Microfinance Industry
IT	Information Technology
km.	Kilometer
MENA	Middle East and North Africa
MFI	Microfinance Institution
MIS	Management Information System
MOI	Ministry of Interior
MOJ	Ministry of Justice
MOL	Ministry of Labor
MSE	Micro and Small-Scale Enterprise
NBFI	Non-Bank Financial Institution
NGO	Non-Government Organization
NIS	New Israeli Shequel
No.	Number
PA	Palestinian Authority
PARC	Palestinian Agricultural Relief Committees
PDF	Palestinian Development Fund
PECDAR	Palestinian Economic Council for Development and Reconstruction
PLC	Palestinian Legislative Council
PMA	Palestinian Monetary Authority
Pop.	Population
SBEF	Superintendency of Banks and Financial Entities
SDR	Special Drawing Rights
SO	Strategic Objective

SOW	Scope of Work
TFP	Total Factor Productivity
UNRWA	United Nations Relief and Works Agency
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	West Bank
WBGS	West Bank and Gaza Strip
YMCA	Young Men's Christian Association

EXECUTIVE SUMMARY

Background

1. The current Palestinian setting makes analysis of the policy, legal, and regulatory environment for microfinance a complex and difficult task at best. While this report recognizes the important political implications of the West Bank and Gaza Strip's (WBGS) status as an occupied territory and the economic consequences of the continuing conflict, it also looks beyond these immediate and pressing concerns to the challenges and opportunities that will face the Palestinian economy if the current crisis is resolved and if development of a microfinance industry becomes a priority for the Palestinian Authority (PA) and donor community. Although the terms of the conflict resolution will largely determine the general economic performance of the WBGS in coming years, addressing the policy, legal, regulatory, and supervisory challenges raised in this report, will be crucial for the successful development of Palestine's microfinance industry.

2. Two attributes of the Palestinian economy point to the expansion of access to microfinance as a potentially useful tool to combat rising poverty and promote equitable growth in the WBGS. First, over 95 percent of businesses in the WBGS are micro or small-scale enterprises (MSEs), that employ less than 10 persons; however, only about one in four of these MSEs has access to loans from the formal banking system, thus preventing most of them from expanding (USAID 2001a). Second, with the most recent estimates of the percentage of the population below the national poverty line at over 60 percent (as of mid-2001) and of the percentage unemployed at around 40 percent, it is evident that a large percentage of those considered poor rely on MSEs for at least part of their livelihood. Development of the MSE sector through expansion of access to sustainable microfinance, therefore, is likely to play an important role in alleviating poverty and contributing to economic growth in the WBGS.

The Policy Environment

3. Market volatility affects risk and therefore business decisions and the performance of financial institutions serving the entrepreneur. In general, greater stability enhances the viability of microfinance institutions (MFIs) and their clients' MSEs. For this reason, the stability of financial and other markets makes microfinance provision more viable (Yaron, Benjamin, and Piprek 1997, and Ledgerwood 1999). Until the peace process leads to a fully autonomous Palestinian government, borrowers and lenders alike will remain wary of unfavorable policies constraining the growth of MSEs and the microfinance industry. That apprehension is by far the most important factor constraining the development of MFIs and the MSEs they serve. Despite the potential significance of microfinance for poverty alleviation and economic growth, microfinance is clearly not a priority on the short-term policy or legislative agenda of the PA or the PMA. However, government articulation of a cohesive, coherent policy framework for Microfinance, is a crucial starting point to facilitate development of a microfinance industry in the WBGS.

4. To minimize further economic deterioration and enable a quicker future return to stable economic growth, the PA will need to maintain strong budget discipline in 2002 and refrain from non-essential expenditures. In addition, the PA should work with the donor community to express prioritized emergency support, to key areas such as budget, basic health and education, job creation, and infrastructure and land rehabilitation. Microfinance should be an integral component of such a support strategy. To assist the PA with its budget shortfalls, Israel should immediately transfer to the PA the customs duties and value added taxes (VAT), on goods imported through

Israel (amounting to approximately \$260 million) that have been collected by Israel on behalf of the PA, but not paid to it since December 2000 (World Bank 2001a, p. 5).

Chairman Arafat's failure to delegate responsibility for economic management to appropriate institutions and experts, has damaged those institutions and the possibility for more rapid development. For effective short-term and medium-term prioritization to occur, two activities must be undertaken. First, the PA needs to define more clearly now the "borders" of responsibilities between its Ministries. Second, the PA requires highly skilled people in order to manage its institutions effectively and efficiently, therefore, developing the skills and experience of its staff is also a high priority (PECDAR, p. 16). Support for capacity building of the Palestinian Monetary Authority (PMA), in terms of general prudential regulation and supervision and specific understanding of microfinance operations, could be a key component to support the development of a Palestinian microfinance industry.

5. Although the PMA considers its mandatory bank lending ratios as targets only, their existence signals a willingness to intervene directly in the financial markets, which in turn could undermine deposit mobilization, if the general public perceives that these lending pressures might undermine bank performance and stability. This direct government intervention should be removed. Experience worldwide with mandatory lending imposed on banks and other attempts to raise the overall level of lending, such as direct government provision of loans at subsidized interest rates, credit guarantees, and directed credit (to certain industries, state-owned enterprises, or agriculture, for example) have overwhelmingly led to a sub-optimal allocation of resources.

6. Until a peace agreement is reached, efforts must be directed at reducing the dependence of the Palestinian economy on Israel for the health of the economy, the operations of MSEs, and the MFIs that serve them. This can be done by securing unimpeded access to more distant markets for Palestinian goods, by establishing a seaport in the GS and allowing airport operation in both the WB and the GS. Transportation and trade links with Jordan and Egypt need to be strengthened. There is also considerable scope for expansion of Palestinian trade with the rest of the World, particularly the European Union (EU) and the U.S. (Middle East Strategy Group 1996). With respect to future trade policy, the IMF and World Bank argue in favor of the PA adopting an open, nondiscriminatory, and transparent trade regime characterized by the absence of quotas and trade monopolies.

7. The Palestinian economy also needs to be integrated by facilitating normal trade relations and movement of people between and within the territories. Lack of free movement poses a series impediment to MSE development and growth, and dampens their demand for microfinance services. This would require establishing free passage between the WB and GS, which takes into account Israeli security concerns (for example, by building a service through road), and restoring economic links between the WB and East Jerusalem.

8. A well defined policy (and legal) framework governing land and water resources needs to be established, to provide a more secure base for domestic and foreign investment, that can provide greater opportunities for microentrepreneurs and a larger client base for MFIs. Improvements in infrastructure are also needed, especially relating to roads and energy. Further consideration should also be given to developing international free trade zones, especially in the GS, in order to absorb part of the currently unemployed Palestinian work force and to encourage investment and technology transfer. The Gaza Industrial Estate is a positive step in this direction, and it is hoped other industrial estates will be established as well, including in the WB.

The Legal Framework

9. In the WBGS, several formal (e.g., banks) and semi-formal institutions (e.g., NGOs and to a lesser extent, cooperatives) have been active in providing microfinance, in addition to various informal providers. The relevant laws and regulations currently in effect, establish varyingly stringent requirements that an entity providing financial services must meet, depending on its characteristics and range of activities. Although microcredit NGO activities are widespread, they are neither formally regulated nor financially supervised. NGOs are supposed to be supervised by the MOI, or by the relevant ministry as indicated in by its registration, but it is widely acknowledged that their supervision is sporadic and weak. According to the Cooperative Law, cooperatives are supposed to be monitored by the Cooperation Department in the Ministry of Labor (MOL), but the MOL's supervision is extremely weak due to a lack of the necessary manpower and skills. A shift of regulation and supervisory oversight of cooperatives from the MOL to the PMA, may instill greater confidence in these institutions and allow them to make substantial progress toward increasing their financial self-sustainability and outreach.

10. Consideration should be given, to developing a new tier of financial regulation and supervision for financial intermediaries specializing in microfinance operations, including voluntary deposit mobilization from the general public. This proposed new tier of financial intermediary might be based on the successful experiences with introducing such a new tier of regulation in Bolivia. Such a new tier of regulation in the WBGS, could be expected to induce progress toward financial self-sustainability of the microcredit NGOs currently active in the WBGS and enhance competition, both of which would serve to enhance the breadth and depth of outreach. The ability of these institutions to mobilize deposits and to obtain deposit insurance, is crucial for their enhanced financial self-sustainability and the development of the microfinance industry in WBGS. Strengthening the supervisory capacity of the PMA as a first step, would be crucial in this regard. Consideration should be given to developing a specialized unit within the PMA, with responsibility for regulating and supervising the microfinance operations of regulated institutions.

11. A comprehensive moveable property law should be enacted, since there is currently a void regarding legislation and registration of movable assets – often the main type of asset held by lower-income microentrepreneurs. The current draft of the Security Interests in Moveable Property Law that has been prepared by the EBRD, provides a good starting point, as it is based on successful secured financing law in provinces of Canada and U.S. The applications of the draft Security Interests in Movable Property Law, include security agreements for movable property, lease contracts for movable property, and sales contracts for movable property.

12. Despite the relative importance of using immovable property as a security interest, mortgage lending has not become widespread and other, less efficient forms of housing finance, have developed. Several measures could overcome this problem. First, the pending restructuring and merger of the three independent departments involved in the land registration process, should be completed, to increase efficiency and reduce administrative costs (as proposed in McGill et al., 2001, pp. 10-12). Consideration should also be given to establishing a network of Information and Registration Centers (IRCs), to act as a data clearing house for both entry and retrieval of land registration information. In addition, the Geographic Positioning System (GPS), should be used to more efficiently register title of land in the WBGS.

13. Another recommendation related to increasing the use of immovable assets as accepted collateral, involves the development of title insurance. It could provide a bridge that makes immediate lending possible, when registrations are delayed by administrative overload. Based on

the findings related to the same recommendation made by Mc Gill et al. (2001, p. 15), PMHC and bank officials have indicated their willingness to accept a properly designed title insurance product. Land registration officials also view it as an opportunity for promoting private sector resolution of title issues and surveys, that will speed the official land registration process.

14. In addition to these interventions that are likely to assist use of land as collateral primarily for commercial lending, other changes could potentially enable a greater number of entrepreneurs operating MSEs, to use immovable property as collateral. Despite the enactment of the 1996 Condominium Law, subdivision remains relatively rare because, with mortgage financing unavailable, developers have no incentive to subdivide. A legislative solution should be developed to permit registration of cooperative, multi-unit housing developments, that have not been properly subdivided. Subdivision and registration of individual units in multi-unit housing developments, should be mandatory, not voluntary. This will permit mortgage financing, and increase the market value of these units (these recommendations are also suggested in McGill et al., 2001, p. 17).

15. Two other recommendations deserve note from the Mc Gill et al. (2001) report. First, consumer protections must be developed, to insure that developers adequately disclose all costs in advance. They rightly suggest revising the draft Capital Markets Authority Law, to explicitly authorize such regulation, as one way to achieve this goal. Second, persons whose rights in land are established by adverse possession, should be entitled to register ownership. They aptly justify this recommendation, by noting that without this ability, subsequent transfers will be forever unregistrable.

16. The McGill et al. (2001) report, also provides excellent recommendations concerning the development of a leasing industry in the WBGS, that is currently absent. Such development would allow MSEs to gain access to short and medium-term capital, for fixed assets. Since a lease is made on the basis of an enterprise's cash flow, rather than on its credit history or asset base, leasing gives MSEs with scarce financial resources, the opportunity to start a business with only limited funds, or to increase productivity through new capital investment. The draft Interests in Movable Property Law and the Tax Code, can provide some of the essential infrastructure to support development of a leasing industry, including a registry of property and a clear tax policy, if they are improved from their current draft statuses. In addition, a clear tax policy, perhaps the most important foundation for development of the leasing sector, is currently missing in WBGS. As the Israeli experience demonstrates, all that is required, is a short "instruction" for application, by taxing authorities. The Minister of Finance appears to have the discretion to issue such an instruction on his own authority. Leasing insurance and a publicly accessible register, can be introduced by private sector initiatives. As the industry develops, establishment of an effective regulatory body like the Capital Markets Authority, would be a useful refinement to enforce best practices, standardization of forms, and complete disclosure of all costs.

17. The shortcomings of the judicial system in the WBGS, are commonly acknowledged and there is also widespread agreement on what needs to be done, to strengthen the legal environment necessary to support MSE development and the MFIs that support them. The most fundamental issue to be resolved, is that the executive and judicial powers need to be separated. Security and military courts weaken the independence and effectiveness of the judiciary, and Palestinians may resolve disputes through appeals to security personnel, rather than in civil courts. Presidential ratification of the "Basic Law" (incorporating constitutional provisions) and "the Independence of the Judiciary Law," passed by the PLC in 1997 and 1998, would separate executive and judicial powers and increase the powers and capacity of the civil courts to adjudicate commercial disputes. Training of judges needs to be substantially increased and in terms of brick and mortar,

adequate facilities in which civil courts can function, are also required (World Bank 2001d, p. 17). Conflict resolution mechanisms, including Alternative Dispute Resolution (ADR), are not widely used in the commercial sector; however, a public opinion survey with regard to the value of establishment of ADR centers throughout the WBGS, indicates that such centers would be viewed positively and widely utilized.

The Palestinian Small and Micro Finance Network

18. Microfinance associations, networks, and support programs, have several important roles to play in the continued promotion of sustainable microfinance. They can spread awareness of key features of the Financial Systems approach, to microfinance among policy makers, development agencies, donors, and practitioners. They can also help to integrate microfinance more with the general financial sector, and to ensure complementary (non-financial) approaches are considered. In addition, they can collect and disseminate microfinance “best practices”, to accelerate the outreach and financial self-sustainability of their member MFIs, in terms of cost-saving technological developments and creation of linkages to expand outreach, to name but a few topics.

19. One of the most pressing areas in which the Network could support a sustainable microfinance industry, is in the area of assisting with the development of an appropriate legal and regulatory framework for microfinance. Certainly, a hospitable legal and regulatory environment has not proved to be a necessary precondition to the development of microfinance elsewhere in the world. In general, improvements to laws and administrative regulations affecting microfinance, have only been undertaken, once the microfinance sector has established itself to the point where its contributions could already be offered as empirical support for the proposed changes. The WBGS, however, manifests a number of distinctive features. Among these, two are particularly relevant, where legal and regulatory issues are concerned. First, the nascent and evolving nature of the legal and economic systems of the WBGS, presents a challenging combination of “holdover” legal and regulatory provisions, and sometimes hastily (and in some cases, poorly), prepared new laws and administrative regulations. Second, many of the bodies of law and administrative regulation most important to microfinance – the banking law, the law of security interests in moveable assets, the law of enforcement, to name a few - are at this moment in the process of development or substantial overhaul, meaning that the microfinance sector now has the opportunity to advocate a sensible legal and regulatory regime, that may diminish in the near the future.

20. Other possible activities envisioned in the short-term for the Network, include:
- 1) Assist in the identification of local capacity building needs; gather and disseminate information on local adaptation of best practices.
 - 2) Coordinate on the delivery of technical assistance and training to MFIs and other stakeholders.
 - 3) Assist in the provision of technical assistance or training to MFIs, as capable.
 - 4) In consultation with others, lead the Palestinian MFIs’ adaptation of standardized accounting and reporting formats.
 - 5) Receive member MFI statements and compile the data in order to inform members and other stakeholders on the development of microenterprise services and their socioeconomic impacts.
 - 6) In consultation with others and its Board, lead the development of standards and ratings for Palestinian MFIs.
 - 7) Improve on the current ad-hoc system of credit reference reporting initiated by several microcredit NGOs (i.e., duplicate loans, blacklisted clients, etc.).

- 8) Carry out relevant research and development on issues important to the development of the sector.

21. An important medium-term objective of the Network, should be to develop educational programs about microfinance for professionals and consumers. At the university and post-graduate levels, faculties of law, commerce and banking, and finance, should include microfinance courses in their current course offerings. Most of them are still following an old classical curriculum, that urgently needs updating. In addition, junior and senior lawyers and members of the judiciary, should be encouraged to enroll in legal education courses that will introduce and update their information, about the legal background and practical applications of microfinance. Also, bankers and employees of different registry departments, are recommended to attend similar courses in order to gain a deeper understanding of microfinance concepts and procedures. The Network can play an active role, in making classes, workshops and seminars available through a variety of educational outlets and promoting attendance. Microfinance educational programs should also be addressed to businesspersons and consumers, who might one day become microfinance clients. The design of such a consumer education program is beyond the scope of this study, but media campaigns and other traditional means of raising public awareness can be utilized.

22. Other possible activities envisioned in the medium-term for the Network include:

- 1) Coordinate or conduct sub-sector analyses (i.e., in-depth market research noting growth areas, contractions, etc.).
- 2) If there is sufficient demand for the service, develop linkages with other microfinance networks, such as the MENA regional microfinance networks, to carry out training for MFIs and training of trainers.
- 3) Establish linkages between semi-formal microcredit providers and banks.
- 4) Assist the government in developing the appropriate legal and regulatory framework, for a private credit bureau to capture the microcredits (under \$10,000) borrowed by MSEs.
- 5) Conduct or participate in business development service (BDS) surveys and market assessments.

Related Topics for Future Research

23. Several topics not able to be sufficiently covered in this report, deserve further analysis. A feasibility study should be undertaken to address the net benefits, constraints, and potential remedies, related to the creation of bank subsidiaries to specialize in microfinance. This may be a short to medium-term solution, to the adverse incentives currently in place for Arab and foreign banks, that deter them from engaging further in microfinance. Another feasibility study should be conducted, to address the establishment of Alternative Dispute Resolution centers. Findings and recommendations from both these studies, have the potential to greatly enhance microfinance provision, especially by formal providers.

24. In addition, a feasibility study should address the potential establishment of an apex institution, primarily to serve as a funding source for semi-formal microcredit providers. A private facility could be capitalized with public, private, and donor funds, or by any combination of these. Establishing this facility could have a positive, long-run impact on the development of a microfinance industry in the WBGS. Provided they meet previously determined quantitative and qualitative indicators on outreach, productivity, efficiency, and operational self-sufficiency, microcredit NGOs and other semi-formal microcredit providers, could have direct access to funds from this facility. Continued access to funds would be contingent upon satisfying certain reporting requirements and operational targets. Ideally, these funds would be disbursed quickly,

be of medium to long-term maturity, and be offered at a cost slightly higher than the average market interest rate paid on savings deposits.

25. Also of potential assistance to semi-formal MFIs, a feasibility study should be conducted to analyze the issues involved in creating a private, nationwide credit bureau. This would involve a thorough review and analysis of existing Palestinian law, to see if new and enabling legislation would be needed to allow for the creation of a private credit bureau and the sharing of consumer credit information, between companies that currently store this info (similar to the U.S. Fair Credit Reporting Act that was originally passed by the US Congress in 1973 and amended in 1997 as well as the recent Jordanian legislation patterned off of it).

26. Finally, primarily to benefit MSEs, an analysis of the various legal and regulatory provisions (and administrative practices) applicable to the registration and operation of legal MSEs, should be undertaken. Such an analysis would take into consideration at least the following common problem areas: registration rules; business premises rules; rules concerning capitalization and the maintenance of accounts in regulated financial institutions; tax and accounting rules, and employment rules. Such a study has the potential to uncover current areas of difficulty (that may lead to depressed demand for microfinance) and to propose business-friendly solutions that could improve several relevant pending laws, both for the benefit of MSEs and the MFIs that serve them.

1. INTRODUCTION

1.1 Two attributes of the Palestinian economy point to the expansion of access to microfinance, as a potentially useful tool to combat rising poverty and promote economic development, in the West Bank and Gaza Strip (WBGS). First, over 95 percent of businesses in the WBGS are micro or small-scale enterprises (MSEs)¹ that employ less than 10 persons; however, only about one in four of these MSEs, has access to loans from the formal banking system, thus preventing most of them from expanding (USAID 2001a). Second, with the most recent estimates of the percentage of the population below the national poverty line at over 60 percent (as of mid-2001) and of the percentage unemployed at around 40 percent, it is evident that a large percentage of those considered poor, rely on MSEs for at least part of their livelihood. Recent events which have disrupted economic activity underscore the link between economic opportunity and poverty reduction in the WBGS, as poverty and unemployment are estimated to have risen sharply since the beginning of the current crisis.² Development of the MSE sector through expansion of access to sustainable microfinance, therefore, is likely to play an important role in alleviating poverty and contributing to economic growth in the WBGS.

1.2 Factors that are particular to the Palestinian setting, make the operating environment of MSEs extremely risky. For example, the MSEs of the WBGS, exist within an occupied territory that does not yet enjoy the certainties and privileges of statehood.³ As such, they are vulnerable to an economy precariously dependent on Israel, a country that has periodically closed borders and impeded the free transit of people and goods, as at present. In addition, the goods and services that MSEs demand as inputs, are highly priced relative to neighboring markets. While this report emphasizes the important economic consequences of the continuing conflict, it also looks beyond these immediate and pressing concerns to the challenges and opportunities that will face the Palestinian economy, if the current crisis is resolved. Although the terms of the conflict resolution will largely determine the country's general economic performance in coming years, addressing the policy, legal, regulatory, and supervisory challenges raised in this report, will be crucial for the successful development of Palestine's microfinance industry.

¹ This report defines microfinance, as the provision of a broad range of financial services such as deposits, loans, money transfers, and insurance, to low-income households and their micro and small-scale enterprises (that employ up to five or ten persons, respectively). Microfinance in the WBGS context, generally refers to loans less than \$10,000 and other small-scale financial services targeted to relatively poor clients, as described above. An MFI is defined herein as a single organization or a unit (within a diversified institution) whose primary business is microfinance. MSEs are considered to be businesses employing up to five persons and from five to 10 persons, respectively, requiring few productive (capital or physical) assets, and generating relatively meager profits. The Palestinian Central Bureau of Statistics 1997 Establishment Survey reported that 97 percent of firms in WBGS had less than 10 employees.

² Since the start of the Intifada in September 2000, the Palestinian economy significantly deteriorated, as a result of a series of protracted border closures and restrictions in trade and commerce. Under the closures, Palestinian workers are not allowed to enter Israel, and exports and imports, if not completely blocked, are highly restricted. There has also been damage to Palestinian infrastructure and private property. Economic costs of these barriers to commercial activity exceed \$1 billion. At the same time, Palestinian unemployment has increased four-fold, to approximately 40 percent and the rate of poverty has increased to 64 percent (IMF 2001, p. 19 and USAID 2001b).

³ Since the 1993 Oslo Agreements, the Palestinian Authority (PA) has acquired jurisdiction in a number of areas, including the delivery of public services, law enforcement, and legislative power, however, Palestinian governance is unique given, their still limited control of land, and lack of control over water, transport of goods and people, or access to external markets (World Bank 2000, p. 1).

A. Objectives

1.3 Building on USAID/WBG's technical assistance to the Palestine Monetary Authority (PMA), this report specifies constraints inhibiting the development of a microfinance industry, and proposes policy, legal, and regulatory improvements to create an enabling environment for microfinance. It specifically includes:

- Analysis of macroeconomic and sectoral policies that affect microfinance, and recommendations on how to improve the policy environment for microfinance;
- Detailed assessments of the legal environment and the banking regulation and supervision practices relevant for microfinance, with suggestions on changes in these to create a more appropriate and efficient legal and regulatory framework for microfinance;
- Findings from discussions with relevant development partners (for example, the World Bank and KPMG Barents), on how efforts to improve the policy, legal, and regulatory environment for microfinance can be coordinated;
- Recommendations on what "value-added" a microfinance association could bring, toward creating a policy, legal, and regulatory framework conducive to growth of the microfinance industry; and
- An action plan outlining practical, realistic, short-term and medium-term steps, that could be taken to help develop and promote microfinance markets in the WBGs.

1.4 Findings of the study are expected to support USAID/WBG in achieving its Strategic Objective (SO) No. 1, "Expanded Private Sector Economic Opportunities", to create sustainable economic opportunities in the private sector for Palestinians in the WBGs. Under this SO, efforts are focused on three major inter-related intermediate results (IRs): 1.1) increased access to financial services; 1.2) increased access to markets; 1.3) an effective program operation of selected economic regulatory institutions (USAID 2001b). The Scope of Work (SOW) that guided the development of this report is attached as Annex 1.

B. Analytical Framework

1.5 The analysis of the WBGs's policies, laws, regulations, and supervision practices, is based on the relatively new school of thought called the "Financial Systems" paradigm, that has replaced the traditional paradigm of subsidized, targeted credit to accomplish development goals, such as increasing agricultural output, helping the poor, etc. The Financial Systems approach considers microfinance as part of a country's general financial services market, focuses on the development of sustainable (subsidy-free) financial institutions, and recognizes that microfinance clients are willing to pay the full cost of these services, if they are designed and delivered consistent with their specific needs (Otero and Rhyne 1994; and Von Pischke 1988). Box 1.1 below explains some of the main tenets of the Financial Systems approach to microfinance.

1.6 Following the Financial Systems approach, this report analyzes the policy environment from both macro and sectoral points of view, including a discussion touching on not only fiscal and monetary policies, but also of the relevant policies affecting the agricultural and financial sectors. In addition, three bodies of law and banking regulation and supervision, offer the basic outline of an analytical framework for the microfinance legal and regulatory environment in the WBGs.⁴ The first relates to MFI legal forms and to prudential regulation and supervision. It includes the rules that govern the formation and registration of legal entities that can be used to

⁴ This framework for analyzing the legal and regulatory issues affecting microfinance service providers is adapted from Lyman 2000.

carry out microfinance activities, as well as prudential regulation and supervision issues that may affect microfinance providers. Second, the various rules governing lending activities and collateral, are discussed. Third, is the set of legal and regulatory rules governing the formation and operation of MSEs themselves, and the clientele of the WBSG's developing MFIs.

Box 1.1: Explanation of the Financial Systems Paradigm

The Financial Systems approach to microfinance focuses on the primary goals of economic development: *income expansion* and *poverty reduction*. It recognizes that providing microfinance may not always be the most cost-effective way of reaching these goals and that effective microfinance intermediation should often be complemented by other government actions. This approach proposes an active role for government in establishing a favorable or “enabling” policy environment, to facilitate the smooth functioning of microfinance markets, but a more limited role in direct interventions. It also emphasizes creating a favorable policy environment, including not only macroeconomic stability, but also reductions in any historical biases against the rural sector; strengthening the legal and regulatory framework for MFIs, including reforms in the titling and registration of land, creation of registries under secured transaction laws, reforms for moveable property to enhance their value as collateral, the elimination of usury laws (for example, interest rate caps), and licensing of specialized MFIs that can provide a variety of financial services, not just credit, to low-income households and their microenterprises.

Sources: Charitonenko and Yaron 2000; and Yaron, Benjamin, and Piprek 1998.

C. Methodology

1.7 This report draws heavily from the draft study, “Review of Policy, Legal, and Regulatory Environment of Micro Finance in Palestine” prepared by Massar Associates. It also incorporates the main findings and recommendations of several other reports relating to private sector development, financial sector development, rural and microfinance (a full list of secondary sources is provided in the Bibliography of this report). In addition, first-hand accounts of the relevant policy, legal, and regulatory issues were provided by various stakeholders, including bankers with experience in microfinance, senior managers of community development financial institutions, technical experts from various consulting firms, and staff of leading international and domestic organizations active in development of the WBSG. Annex 2 provides a full list of persons consulted.

D. Organization

1.8 This report is divided into five sections. Section 2 addresses the policy environment, taking into account policies at both the macroeconomic (fiscal and monetary) and sectoral (agricultural and financial) levels. Section 3 analyzes the legal environment for microfinance, covering issues surrounding the formation and registration of microfinance providers, prudential regulation and supervision, the rules governing lending activities and collateral, and the set of legal and regulatory issues governing the formation and operation of MSEs. Section 4 summarizes progress made toward the establishment of the Palestinian Small and Micro Finance Network, and suggests objectives and activities for the Network, so that it can have substantial positive impact on the development of a sustainable microfinance industry in the WBSG. This report concludes with Section 5, which summarizes main findings, short-term and medium-term recommendations, and topics for future research.

2. THE POLICY ENVIRONMENT

2.1 Key issues in the policy environment for microfinance in WBGS are described below. These include the country's recent economic performance, key indicators for socioeconomic conditions, and relevant macroeconomic and sectoral (especially agricultural and financial) policies. These areas of analysis provide the country context necessary, to determine whether changes in macroeconomic or sectoral policies are required to facilitate the development of a microfinance industry in the WBGS.

A. Recent Economic Performance and Key Socioeconomic Data

2.2 Economic performance of the WBGS remains hinged on developments in the Israeli-Palestinian peace process. Since September 2000, the Palestinian economy has been severely constrained in terms of output and income by the Israeli-Palestinian conflict and related border closures and restrictions, in the movement of people and goods. Before the start of the latest conflict, however, the Palestinian economy was benefiting from reasonably optimistic views regarding the future, and it was set to enjoy a fourth consecutive year of growth in income per capita (Table 2.1). Unemployment had fallen from over 28 percent in the first quarter of 1996, to 11.8 in 1999 and to 10.0 percent in September 2000 (IMF 2001, p. 5). Progress was also being made in the recurrent budget balance, improving from a deficit of four percent of GDP in 1996 (on a commitment basis), to a surplus of roughly one percent of GDP in 1999.⁵

Table 2.1: Selected Macroeconomic Indicators

	1995	1996	1997	1998	1999	2000
Real GDP growth ¹	-2.4	-3.2	4.8	7.0	6.0	-1.5
Real GNI growth	-4.3	-4.6	7.6	11.9	7.2	-4.9
Real GNI per capita growth	-9.6	-9.0	3.4	7.7	3.3	-8.3
Consumer price inflation ²	10.0	8.4	7.6	5.6	5.5	2.8
Unemployment rate ³	18.2	23.8	20.6	13.2	11.8	14.1
Structure of the Economy (% of GDP)						
Agriculture					8.4	7.7
Industry					28.9	27.1
Manufacturing					16.4	15.1
Services					62.6	65.2
Notes:						
1. Real GDP Growth reflects change in percent from previous year and the data for 2000 is based on projections made in mid-2000.						
2. Consumer price inflation is based on change in percent from previous year.						
3. Unemployment rate is expressed on an annual average basis as a percent of the labor force.						
<i>Sources: IMF staff estimates and projections (presented in IMF 2001, p. 5) are based on data from the Palestinian Central Bureau of Statistics. Data on structure of the economy is based on World Bank estimates presented in, "West Bank and Gaza at a Glance"(World Bank 2001c, p.1).</i>						

2.3 The dramatic economic deterioration from September 2000, reveals the extent of Palestinian dependence on Israel. The loss of labor income from Palestinians working in Israel

⁵ This turnaround was prompted by the phasing-out of general budgetary support provided by donors – since 1998, no such support has been provided until the latest crisis – and it was made possible by the strong growth in revenue, together with some constraint in overall recurrent expenditure (IMF 2001, p. 15).

(about 25 percent of total labor income) and non-remittance of approximately \$260 million⁶ in customs duties and value-added taxes (VAT) collected by Israel on behalf of the PA, has induced sharp reductions in gross national investment (GNI), private consumption, exports, and imports.⁷ Per capita real income declined by 12 percent for 2000 as a whole, and is anticipated to decline by another 18 percent over 2001 (World Bank 2001a, p. 5). As of December 2000, fiscal revenue was running at about 55 percent below normal, and the budget shortfalls are now almost exclusively financed by external assistance. In the first 10 months of the Intifada, \$442 million of donor aid was disbursed, and by the end of 2001 disbursements are expected to exceed \$800 million for the calendar year, with 75 percent of the funds devoted to budget support and emergency relief (World Bank 2001a, p. 2).

2.4 The economic downturn is amplified by the WBSGS having a relatively low population (about 3.0 million), coupled with a dramatically high population growth rate of four percent per annum, resulting in the population naturally doubling every 20 years. Given the youthful composition of its labor force, labor force participation rates are unusually low at about 50 percent for the WB and only 40 percent for the GS. This low level of “economically active” people also reflects the very low (15 percent) participation of women, and implies a high dependency ratio of one employed person for five others (Table 2.2) (World Bank 2000, p. 1 and MOL 2001, p. 3).

Table 2.2: Percentage Distribution of Labor Force Participants by Age and Sex

Age Interval	Males (%)	Females (%)
15 – 19	40.1	10.5
20 – 24	35.5	37.6
25 – 29	27.3	20.7
30 – 34	24.7	12.6
35 – 39	22.0	5.5
40 – 44	25.1	6.7
45 – 49	21.1	2.3
50+	15.7	0.5
Average	26.9	15.3

Source: MOL 2001, p. 3

2.5 Despite the poverty that is currently estimated to affect over 60 percent of the total population, the WBSGS has achieved human development outcomes that exceed the average indicators for other countries in the Middle East and North Africa (MENA) region, as well as the average attained by other lower, middle-income countries (Table 2.3). Literacy rates are 86 percent for the total population aged 15 and up, and over 95 percent of the population aged 20-24 is literate, with no significant literacy differences between young men and young women. This implies that literacy rates for the population as a whole are on a positive path, as new generations complete their education. Furthermore, about 95 percent of school-aged children, both boys and girls, are enrolled and receive formal education. The health level of the Palestinian people is

⁶ Since December 2000 no such payments have been made (World Bank 2001a, p. 2).

⁷ In recent years, over 90 percent of Palestinian exports have been to Israel and about 75 percent of its imports have been from Israel (World Bank 2000, p. 1). While Israeli exports to the WBSGS have been virtually unimpeded during the current crisis, Palestinian exports to Israel and to the rest of the world have declined sharply under the restrictions.

better than most of the region, as indicated by their longer-than-average life expectancy of 71 years and low infant mortality rate of about 15 per 1,000 live births (World Bank 2000, p. 1).

Table 2.3: Key Socioeconomic Data, 2000 (est.)

	WBGs	MENA	Lower, Middle- Income Countries
Population (million)	3.0	296	2,046
Population growth (avg. ann. % chg., 1994-2000)	4.5	2.0	1.0
Labor force growth (avg. ann. % chg., 1994-2000)	4.7	2.8	1.3
Life expectancy at birth (years)	72	68	69
Infant mortality (per 1,000 live births)	15	44	32
Illiteracy (% of pop. aged 15 years and up)	14	35	15
Gross primary enrollment (% of school-age pop.)	97	95	114
Male	97	102	116
Female	96	88	114

Source: World Bank 2001c, p. 1.

B. Macroeconomic and Sectoral Policies

2.6 Macroeconomic and sectoral policies that affect the MSE development and microfinance, are examined below. Market volatility affects risk, and therefore business decisions and the performance of financial institutions serving the entrepreneur. In general, greater stability enhances the viability of MFIs and their clients' MSEs. For this reason, the stability of financial and other markets, makes microfinance service provision more viable (Yaron, Benjamin, and Piprek 1997, and Ledgerwood 1999). Interest rate controls, agricultural or rural sector lending mandates or promotion programs, and import/export promotions or restrictions, are all examples of the types of macroeconomic and financial sector policies that are important to consider, due to the clues they provide about the opportunities available to microentrepreneurs and potential microcredit demand, the forecasted growth and funding requirements of the MFI, and the design of loan contracts, deposit products, or other services, that an MFI might offer.

2.7 There are three general characteristics of a policy environment that is conducive to the growth of MSEs and the MFIs that serve them. These are:

- Positive and stable economic growth (discussed below);
- Low and steady inflation (achieved currently); and
- A secure investment climate with no undue barriers to business entry, operation, or exit (analyzed in Section 3.C.).

In attempting to achieve and maintain the above, many countries have succumbed to several common macroeconomic and sectoral policy pitfalls, that have proven unconducive to the development of the MSE and microfinance sectors. These include:

- Overvalued exchange rate (not an issue in WBGs since they have no domestic currency at this time);
- Direct government intervention in financial markets (such as mandatory lending imposed on banks, direct provision of targeted or subsidized loans, or usury laws) that "crowd out" private sector MFIs (discussed below);

- Underdeveloped legal and regulatory provisions regarding land titling and collateral for typical rural assets (land, crops, and farm implements), relative to urban assets (cars, durables, and homes) (analyzed in Section 3.B);
- Disproportionately high budgetary allocations for urban over rural infrastructure (roads, electricity, and water supply) (discussed below);
- Disproportionately high investment in human resources in urban over rural areas (health and education) (discussed below);
- High effective rates of protection for domestic industry, the outputs of which are used as agricultural inputs (not currently an impediment, although effort will be needed to ensure domestic industrial protection does not emerge); and
- Low, controlled, and seasonally invariant prices for agricultural products and excessively taxed agricultural exports (also not an issue now, but indicative of types of policies to avoid in the future).

2.8 Considering the above, the most pressing challenge facing the PA in terms of providing a conducive policy environment, is **resolving the current political and economic crisis**. With this accomplishment, the PA will also need to maintain strong budget discipline and refrain from non-essential expenditures, as well as continue work on prioritizing emergency support needs (including infrastructure and human resource development) with the donor community, in accordance with their medium-term economic development plans. For effective prioritization to occur, two activities must be undertaken. First, the PA needs to define more clearly now the “borders” of responsibilities between its Ministries. Second, the PA requires highly skilled people in order to manage its institutions effectively and efficiently, therefore, developing the skills and experience of its staff is also a high priority (PECDAR, p. 16).

2.9 As part of efforts to promote positive and stable economic growth in the WBGS, several demographic changes need to be considered. Important current demographic changes and those likely to occur under a scenario of conflict resolution, are discussed next. Following this, specific issues related to the common policy pitfalls highlighted above, are analyzed.

2.10 **Demographic Changes.** Significant demographic changes are now underway in terms of overall population growth, and the expected increase over time in the percentage of the population reaching working age (people aged 15 – 60 years). In addition, a permanent status agreement for the Palestinian territories would imply settlement of the refugee question, and subsequent migration (most estimates are for one million people or more) could be expected into the WBGS. The resulting boost to population growth would amplify the demographic challenges already posed by the high population growth rate, relative to providing sufficient job opportunities and implementing growth-enhancing policies, would become even more pressing. This could lead to a period of high unemployment or declining real wages, or both, depending on the short-term policy choices.

2.11 **Implications for Economic Growth.** Under plausible assumptions regarding demographics and labor force participation rates, the labor supply would increase by 4.4 percent a year during 2001 – 2010. For these inflows to be absorbed into productive employment, at the same time as the high unemployment rate is reduced, domestic employment must expand by about 6.5 percent annually. To achieve this employment target, real annual rates of growth in real GDP, must be at least eight percent and total factor productivity (TFP) of 1.2 percent (IMF 2001, p. 2). Although this seems an extraordinary challenge for the Palestinian economy, such growth rates have been attained in the past. On average over the last 30 years, GDP growth averaged six percent and TFP growth 1.4 percent, albeit with substantial annual variation (IMF 2001, p. 2).

2.12 Introduction of a Palestinian currency. The introduction of a Palestinian currency has received some attention and will surely receive more in the future; however, this should be considered only a long-term issue, as the present system with three currencies works well. Currently, the New Israeli Shequel (NIS) , the Jordanian Dinar, and the U.S. Dollar, circulate freely and provide a good degree of stability.⁸ The risks of introducing a Palestinian currency outweigh the foreseeable benefits, at least in the short and medium term. This is mainly due to the fact that most PA policy institutions, including the PMA, do not yet attract credibility and confidence, since many of them are young and still in the process of establishing themselves. The transparent and simple institutional framework to effectively constrain the scope for discretionary monetary policy, simply does not yet exist.

2.13 Direct Government Intervention in Financial Markets. Although not strictly enforced, the PMA has responded to pressure to increase bank domestic lending, by introducing a floor on the ratio of lending to deposits (40 percent) and a ceiling on the ratio of foreign assets to deposits (65 percent). Although the PMA considers these ratios as targets only, their existence signals a willingness to intervene directly in the financial markets, which could in turn undermine further growth – even precipitate a decline – in deposits, should depositors become uncomfortable with the increased risk in banks’ lending activities (IMF 1999, p. 35). This direct intervention should be removed, as experience worldwide with mandatory lending imposed on banks and other attempts to raise the overall level of lending, such as direct government provision of loans at subsidized interest rates, credit guarantees, and directed credit (to certain industries, state-owned enterprises, or agriculture, for example), have overwhelmingly led to a sub-optimal allocation of resources.

2.14 Expanding trade and setting tariffs and quotas. Given Palestine’s small domestic market and weak resource base, trade policy is another of the most important policy issues facing the PA that will affect its economic future. Israel’s large share in Palestinian exports and imports, is not in itself evidence of trade distortions,⁹ but a good case can be made that the security restrictions and complex and costly trade and transportation procedures, have tended to lower overall trade and to skew its composition in favor of trade with Israel. There is considerable scope for expansion of Palestinian trade with the rest of the World, particularly the European Union (EU) and the U.S. With respect to future trade policy, the IMF and World Bank argue in favor of the PA adopting an open, nondiscriminatory, and transparent trade regime, characterized by the absence of quotas and trade monopolies. The IMF 2001 (pp. 93-99) also makes the case for the PA to adopt a low, uniform import tariff rate, of between 5 – 10 percent across the board.

2.15 Infrastructure development priorities. Given the prolonged neglect during the period of occupation, the infrastructure stock in the WBGS has deteriorated and is inadequate. It compares poorly with other countries of the same income group and also with the MENA region as a whole. Current priorities in infrastructure include energy, roads, water, and wastewater. Particular issues relating to each of these areas are discussed below.

⁸ Article IV of the Economic Protocol of 1994 stipulates that the NIS will be one of the circulating currencies and that it will legally serve as means of payment for all purposes, including official transactions, and further, that any circulating currencies, including the NIS, will be accepted by the PA and its institutions, local authorities, and banks when offered as a means of payment for any transaction (IMF 1999, p. 30).

⁹ Based on IMF estimates of trade flows using a gravity model. Results from this model find no significant evidence that trade between Israel and the WBGS during 1995-1998 is higher than what might be expected given their proximity, respective GDPs, populations, and other variables (IMF 2001, p.2)

2.16 **Energy.** The Palestinian power systems are old and inefficient; electricity suppliers are unreliable; generating is highly dependent on Israel; and the institutional framework is weak and highly fragmented. Consumption, which is a good indication of the health of the economy, is considerably below regional levels. Over 130 villages in the WB have no electricity or are supplied for only a few hours a day. Priority should be given to rehabilitate existing networks and extend services. In addition, the power industry should be privatized, leaving the public sector responsible for rural electrification and inter-regional connections.

2.17 **Roads.** The WB has 2,000 km of roads and the GS has 168 km. The main road network (which stretches about 700 km) was largely constructed prior to 1967 and serves the major population centers. The regional network of roads (covering about 500 km), mainly serves to link Israeli settlements with the metropolitan centers. Outside the municipal boundaries, roads serving Palestinian towns and villages have been funded largely from Palestinian resources. Much of the local road links have deteriorated badly, due to a lack of routine maintenance and regular resurfacing. To facilitate trade and commerce both within the WBGS and with its neighbors, the PA needs to undertake a major program of rehabilitation, construction, and maintenance of its inter-urban and village access road networks.

2.18 **Water.** The water supply system currently serving Palestinians, dates back to the British Mandate period and is now virtually obsolete. There are no drinking water networks for over 120 villages in the WB. A joint Israeli-Palestinian committee controls water resources and as a result, there is a shortage of drinking water and an increasing dependence on Israeli sources of supply to meet local needs. The water system is also decentralized, which makes it impossible to transfer water from surplus regions to deficit areas. Moreover, this decentralization also inhibits the ability of the authorities to mix water of different qualities, in order to economize in the use of fresh water.

2.19 **Wastewater.** Similarly, the wastewater disposal system in the WBGS is inadequate. Even in densely populated areas, most communities dispose of raw sewage in cesspits, polluting underground aquifers. Sewage treatment plants, where they exist, are unfit and require extensive maintenance or rehabilitation. New treatment plants could also increase water availability for agricultural purposes.

2.20 The Gaza Industrial Estate (GIE) under now development and others planned as such, will be an important means to overcome some of the infrastructure barriers noted above and to facilitate the development and expansion of medium and large-scale firms. Although the industrial estates can be expected to provide much needed job growth, it is likely that the remaining weaknesses in infrastructure will continue to dampen the development prospects for MSEs, until substantial improvements, especially in the areas of energy supply and roads, are made.

3. THE LEGAL FRAMEWORK

3.1 Three bodies of law and banking regulation and supervision are analyzed in this section. The first relates to legal forms for financial institutions and to prudential regulation and supervision. It includes the rules that govern the formation and registration of legal entities that can be used to carry out microfinance activities, as well as prudential regulation and supervision issues that may affect microfinance providers. Second, the various rules governing lending activities and collateral are discussed. Third is the set of legal and regulatory rules governing the formation and operation of MSEs themselves, and the clientele of the WBS's developing MFIs.

A. Legal Forms and Regulation and Supervision

3.2 In the WBS, several formal and semi-formal institutions have been active in providing microfinance, in addition to various informal providers.¹⁰ A number of different legal forms have been employed by the formal and semi-formal institutions, as vehicles for microfinance. The relevant laws and regulations currently in effect establish varying stringency requirements that an entity providing financial services must meet, depending on its characteristics and range of activities. These prudential rules, however, remain less closely tied than would be ideal, to the specific risks presented by financial service activities, ranging from simple extensions of credit, to limited deposit-taking from members, to full-scale collection of deposits from the general public.

3.3 Microcredit can be provided through banks, cooperatives, and NGOs. The PMA authorizes only licensed banks to engage in financial intermediation (this entails the mobilization of voluntary deposits in addition to the provision of credit). In addition to banks, PMA Law No. 2 of 1997 allows for "Specialized Lending Institutions", though none to date have been licensed as such. Background on the development of the PMA and the banking sector is provided next, followed by analysis of the establishment and reporting rules governing cooperatives and NGOs.

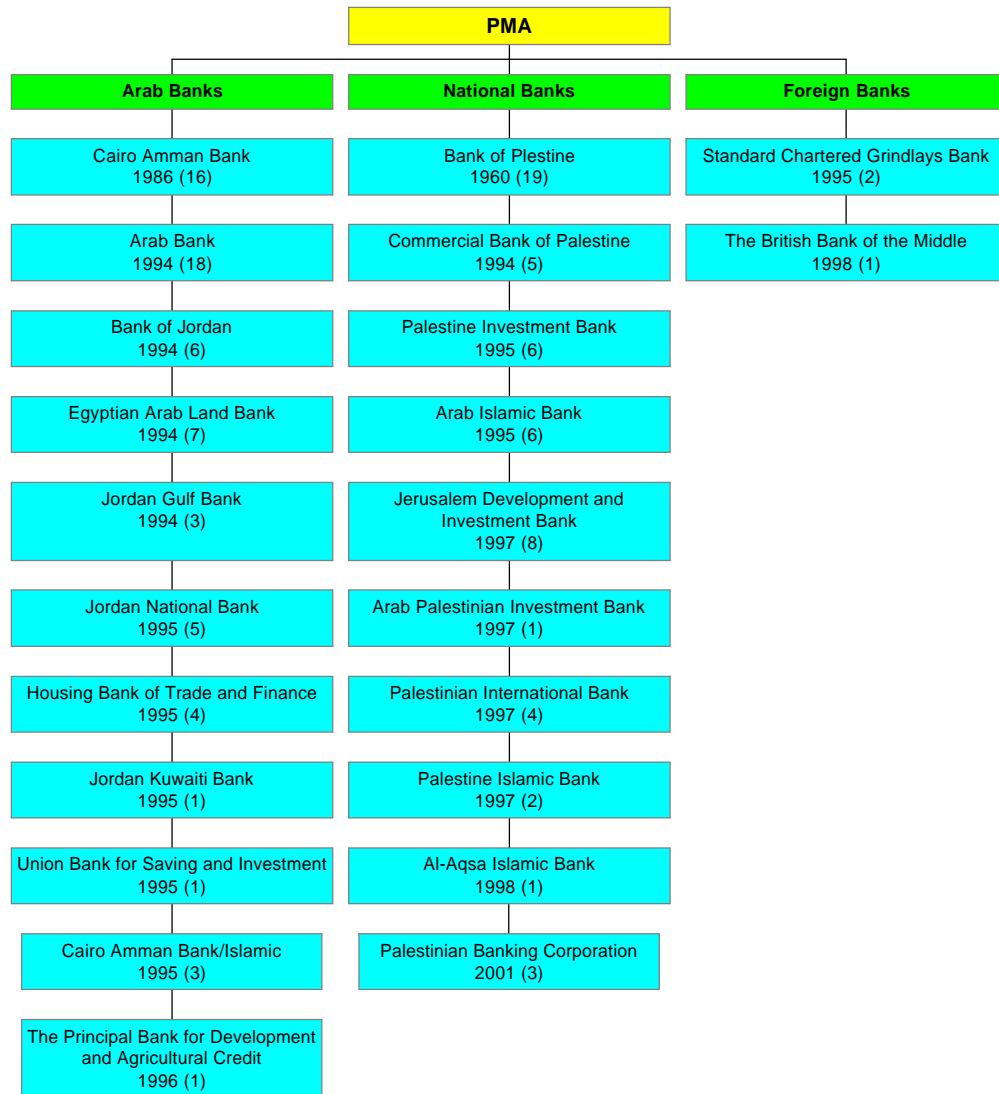
3.4 **Development of the Banking Sector.** The Palestinian economy prior to 1994 suffered from a prolonged absence of a viable banking system (see Hussein 2000, p. 3 for historical details concerning the banking industry in WBS). Movement toward establishing the PMA at the end of 1994 marked the beginning of the Palestinian leadership's awareness, of the importance of establishing a national authority responsible for regulating and supervising banking activities, to establish a safe and sound banking system.¹¹ The PMA became the supervisory body for all banks operating in the Palestinian Territories on December 20, 1995. The PMA Law enacted in 1998 vests the PMA with authority to regulate and supervise the banking system. The Banking Law, however, still remains in draft form after at least five years of revisions. The absence of a Banking Law detracts from the PMA supervisory authorities, and dilutes confidence in the banking system. Despite this, the number of banks operating in Palestine has increased

¹⁰ "Formal institutions" are defined as those that are subject not only to general laws and regulations, but also to specific banking regulation and supervision. *Semi-formal institutions*, are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial laws, but informal insofar as they are, with few exceptions, not under bank regulation and supervision. *Informal providers* (generally not referred to as institutions), are those to which neither special banking law nor general commercial law applies, and whose operations are such that disputes arising from contact with them, often cannot be settled by recourse to the legal system" (Ledgerwood 1999).

¹¹ Banking institutions are established as companies under the Companies Law (No. 16 of 1964) and are registered at the Companies Registrar in the Ministry of Economy and Trade in the WB and at the MOJ in the GS by virtue of Companies Ordinance (No.18 of 1929) and its amendments.

from two in 1993 to 22 as of mid-2001, with 120 branches and head offices (Figure 3.1). Ten banks are Palestinian and the others are regional Arab and foreign banks.

Figure 3.1: The Palestinian Banking System



Notes:

1. Data listed by bank name, year established, and number of branches.
2. Total number of branches is 120 (65 for Arab Banks; 52 for National Banks; and 3 for Foreign Banks).

Source: PMA 2001, www.pma-palestine.org/.

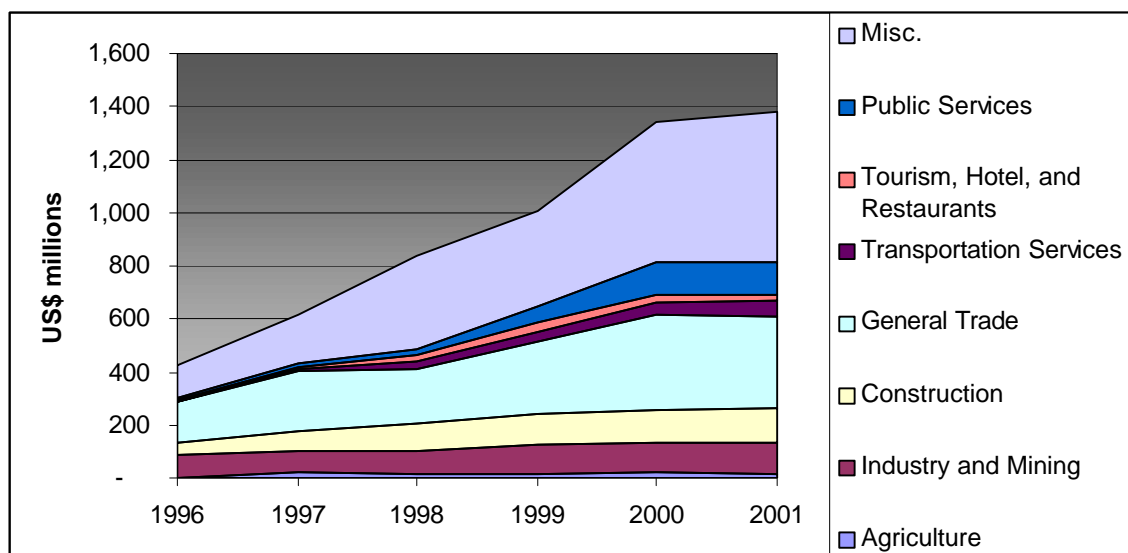
3.5 Three major (Jordanian) banks jointly share two-thirds of the market (in terms of total assets) as at mid-1999; namely, Arab Bank (with 39 percent), Cairo-Amman (18 percent), and the Bank of Jordan (8 percent). This concentration is due to several factors, including depositor

familiarity with these banks and their perceptions that they are more secure and experienced than the newer local banks, and the fact that these banks are subject to supervision by their home countries.

3.6 Total bank deposits grew from \$170 million in 1992, to \$1.7 billion in 1996, and to about \$3.4 billion as of May 2001 (deposits of resident customers were \$3.2 billion at the end of the period). Bank credit to resident customers rose from \$380 million in 1996 to \$821 million as of May 2001. At the end of the period, total bank credit amounted to \$1.3 billion. Total bank credit to the private sector (in dollar terms) increased by 22 percent a year on average in 1997 – 1999 (from 11 percent of GDP at end-1996 to 22 percent of GDP at end-2000), while private sector deposits in the banking system (also in dollar terms) grew by 15 percent on average during the same period (from 39 percent of GDP at end-1996 to 77 percent at end-2000) (IMF 2001, p. 9). Nevertheless, deposits continue to outweigh credits by a significant amount. On average, bank credit facilities to resident customers currently amount to only about one-third of deposited funds of resident customers.

3.7 A breakdown of total bank credit by economic activity, is provided in Figure 3.2. Although no direct verification could be made during the time allotted for study, it is believed that loans to the PA (\$323 million as at May 2001) account for the bulk of the miscellaneous category. Credit for internal trade comprised about 20 percent of loan funds as of March 2001, external trade about eight percent, imports another eight percent (all included in the “General Trade” category below), and public services about 10 percent. Public contracting accounted for about five percent of credit (part of the “Construction” category). It is clear that lending to the government comprises a substantial percentage of the total bank credit provided, likely over one third of the total.

Figure 3.2: Distribution of Credit Facilities by Economic Activity



Notes:

1. 2001 data is as of March 2001.

2. Industry accounts for over 98 percent of credit of the category, "Industry and Mining" in all periods.

Source: PMA 2001, www.pma-palestine.org/.

3.8 The low loan-to-deposit ratio and the predominance of lending to the government by banks, is a risk-averse response to conditions of substantial political and economic uncertainty, coupled with an underdeveloped legal framework, lack of adherence to accounting standards, and relatively inexperienced regulating institutions. The main reasons for the disparity between deposited and lent funds, can be summarized as follows:

- the unstable political and economic environment that makes investment highly uncertain;
- the scarcity of adequate collateral, normally provided by property, mainly due to a lack of proper titling and registration of land;
- an under-developed judicial system, especially relating to settling commercial disputes;
- inexperience of the Palestinian population in using the banking system;
- a lack of acceptable feasibility studies on which banks can depend to evaluate projects;
- the problems experienced by MSEs in providing adequate financial documentation to support a loan application;
- the prolonged closure of the Palestinian territories by Israeli authorities, that undermines banking activity and discourages banks from making new loans, especially of medium to long term (PECDAR, 2000, pp. 10-12).

3.9 In addition to the above, particular operations and practices of the Arab and foreign banks have had a restrictive effect on lending:

- remote decision-making, as headquarters are not directly in touch with local market;
- keeping significant share of assets as deposits at headquarters and reliance on headquarters for liquidity;
- hindrance of the domestic inter-bank market, because of this type of branch-headquarters relationship; and
- traditional lending to customers with long-standing credit-worthiness and who have established themselves in other market older than the Palestinian.

3.10 **Provision of Microcredit to MSEs.** Financial intermediation by banks has been generally limited in the WBGS, largely due to insecure property rights and this has particularly damped lending to MSEs. The traditional assets required as loan collateral are personal guarantees and land with clear title (specific property rights issues and proposed remedies are discussed in the Sub-Section 3.B.). Encouraged by donors, some banks have lent to MSEs by employing new project assessment criteria, such as using cash-flow analysis in place of traditional, collateral-based lending. By March 2000, three banks had approved 695 loans to MSEs, with a value of \$7.9 million, with technical assistance and funds provided by the IFC – World Bank Microenterprise Project.

3.11 In addition to banks, there have also been a number of semi-formal providers of microcredit. According to the Weidemann Associates report of 1999 (the latest survey results available), the total supply of microcredit as of June 1999 was about \$78 million, of which \$57 million was channeled through banks and the remaining \$21 million, through microcredit NGOs and the UN agency, UNRWA. The same report concludes that the outstanding loans then amounted to about \$41 million in 20,492 loans. For this supply-side data to be meaningful as a gauge of microcredit market development; however, it must be compared with estimates of (potential) demand for microcredit.

3.12 A comparison of two sources of data provides a reasonable indication of microcredit demand. The 1999 Weidemann Associates (II-p. 2) report, noted there were around 74,352 (registered and unregistered) MSEs in the WBGS. These were split 53 percent trading, 20 percent

small-scale manufacturing, 19 percent services, and nine percent agriculture (Figure 3.3). Given that agriculture and trading was assumed to be slightly underestimated given the survey techniques employed, the total number of MSE's was expected to be closer to 80,000. Assuming that only half of these would be willing and able to borrow at any given time, implies that total demand in terms of the number of microcredit loans, is about 40,000. Indeed, this figure is corroborated by a 2000 UNRWA report estimate of 43,000 potential microcredit borrowers. Comparison of satisfied demand (supply) and potential demand figures, indicates that perhaps as much as half of the market for microcredit is presently satisfied. These figures, however, must take into account the expected decline in microcredit lending since the start of the Intifada. When both the dampened supply of loans and depressed demand are taken into account, it can be reasonably assumed that between one-third to one-half of the microcredit market is satisfied.

Table 3.1: Number and Total MSEs in the WBS by Economic Activity

Economic Activity	Number of MSEs	Percentage of Total MSEs (%)
Trading	39,359	52.8
Manufacturing	14,891	20.0
Service	13,920	18.7
Agriculture	6,352	8.5
TOTAL	74,562	100

Note:
 1. Data is based on the last know survey conducted in 1997.
 Source: PMA 2001, www.pma-palestine.org/.

3.13 As noted above, several semi-formal microcredit providers (nine microcredit NGOs¹² and UNRWA) have been effective at reaching microcredit clients, despite the systemic weaknesses that often impede traditional commercial approaches to credit. They have mitigated information barriers by decentralizing borrower appraisal and loan decision making, to the level of the clients. In addition, they have employed non-traditional collateral such as peer pressure, character references, close client monitoring by loan officers, and the prospect of continued access to microloans, to enhance repayment rates. Their ability to adapt their lending operations to the particular circumstances of their clients, is due to their not being subject to the prudential regulations and supervision set forth by the PMA to govern licensed banks.

3.14. NGOs are established by the Charitable Societies and Non-Governmental Institutions Law No. 1 of 2000 and are registered at the Ministry of Interior (MOI). For registering an NGO, the MOI may consult with other "competent ministries", depending on the activities of the NGO. NGOs are expected to report their activities and keep statutory books according to the provisions of the law and its regulations. Along with the "competent ministry," the MOI has the right to oversee the financial activities of NGOs.

3.15. The extent of involvement of cooperatives in microfinance is unclear; however, it is widely expected that their activities are only nominal. It is evident, however, that they can legally engage in microfinance and may therefore play a larger role in the future. Cooperative societies are established by the Law of Cooperative Societies No. 17 of 1956 and are registered as "savings

¹² These are ANERA (American Near East Refugee Aid), ACAD (Arab Center for Agricultural Development), CARE International, CWEP (Center for Women's Economic Projects, FATEN (Palestine for Credit and Development), Palestine-German (DEG) Business Start-Up Program, PARC (Palestinian Agricultural Relief Committees), PDF (Palestinian Development Fund), and YMCA (Young Men's Christian Association).

and lending associations.” Massar Associates reported that most of the saving or deposit programs initiated by cooperatives, had only very limited results because of lack of registration or effective supervision.

B. Prudential Regulation and Supervision

3.16 This section reviews bank prudential regulation and supervision as well as the relevant regulations concerning NGOs and cooperatives. In addition, when and how microfinance activities should be regulated and supervised, is discussed. This section concludes with an analysis of the feasibility of promoting a new tier of legislation to govern microfinance providers.

3.17 **Banks.** There are two types of licenses granted by the PMA for locally-incorporated banks: Class A, which applies to basic commercial banks, and Class B, for banks wanting to invest a larger share of their capital in equity investment (for example, investment banks and Islamic banks)¹³. The minimum capital is \$10 million for Class A licensed banks and \$20 million for banks with a Class B license. Foreign banks are allowed to open a branch in WBGS provided they have a “letter of comfort” from their home supervisor and that their branch has a minimum capital endowment of \$5 million (IMF 1999, p. 32).

3.18 Locally incorporated banks in the WBGS must observe a risk-weighted capital adequacy ratio of 10 percent (cash and loans with cash collateral have zero weight while all other assets have a risk weight of 100 percent). All banks are subject to four percent minimum cash ratio and a 25 percent liquid assets ratio. Regarding risk concentration, locally incorporated banks’ exposure to individual debtors cannot exceed the equivalent of 10 percent of their capital base. Open currency positions are limited to five percent of capital base for each of the three circulating currencies, and to 20 percent of capital for all other currencies in aggregate (IMF 1999, p. 32). The PMA reduced banks statutory reserves down 10 percent on Jordanian Dinars, 10 percent on US Dollars, and 8 percent on Israeli Shekels and kept the reserves without interests.

3.19 **NGOs.** NGOs are supposed to be supervised by the MOI, or by the relevant ministry as indicated by its registration, but it is widely acknowledged that their supervision is sporadic and weak. Although NGO activities are widespread, they are neither formally regulated nor financially supervised. The PMA envisions a future role for itself as a supervisory body for NGOs, because it wishes to maintain accurate records of domestic cash flows and NGOs receive significant cash inflows from foreign donors. Most NGOs interviewed do not object to PMA supervision, as most NGOs undergo voluntary annual audits and make financial records available to the public. The prospect of additional supervision is acceptable to most NGOs, provided that the supervisory authority demonstrates sufficient knowledge and understanding of microfinance activity. NGOs are hopeful that they might soon transition their roles into that of specialized banks focusing on microfinance, based upon similar successful experiences in Bolivia and Indonesia. Strong support exists in the NGO community to become regulated as a means to tap market-based sources of funds, such as voluntary deposits that could help them to sustainably increase their outreach to MSEs.

3.20 **Cooperatives.** According to the Cooperative Law, cooperatives are supposed to be monitored by the Cooperation Department in the Ministry of Labor (MOL), but the MOL’s

¹³ In practice, Islamic bank lending is similar to ordinary commercial banks. Types of collateral accepted and procedures are the same, and the difference lies in the interest that is determined as “profits.” Besides differences in licensing requirements noted above and the treatment of interest as profits, no other substantial variations exist.

supervision is extremely weak due to a lack of the necessary manpower and skills. As with the case of NGOs, a shift of regulation and supervisory oversight of cooperatives from the MOL to the PMA, may instill greater confidence in these institutions and allow them to make substantial progress toward increasing their financial self-sustainability and outreach. The next section explores this concept further by analyzing when and how microfinance activities should be subject to regulation and supervision.

3.21 When and How Microfinance Activities Should be Subject to Regulation and Supervision. A controversial global issue in the field of Microfinance, is how to proceed with the legal and regulatory system for MFIs. While there is a broad consensus that the long-run future of microfinance with significant outreach lies in licensed, regulated institutions that can mobilize and intermediate savings, views differ on whether:

- early establishment of a legal and regulatory framework enhances investment and expansion of MFIs, by creating a more predictable operating environment; or
- a “rush to regulate” is likely to be counterproductive, by constraining innovation and natural maturation in a nascent industry and imposing regulatory burdens, that central banks (or delegated authorities) are ill-equipped to handle.

3.22 There are two areas of increasing consensus. First, since approximately 85 percent of MFIs worldwide do not take voluntary deposits from the public, there is no strong reason for prudential oversight of such MFIs, since protection of depositors is usually viewed as the principal rationale for such oversight (CGAP 1996, p.1). Second, for those MFIs that do accept deposits, a tailored set of prudential guidelines and supervision guidelines, is increasingly gaining acceptance. Areas of common adaptations include those found in Box 3.1.

3.23 As noted, this topic has inspired growing discussion in microfinance circles worldwide over the past several years, as commentators have come to understand *inappropriate* approaches to regulating and supervising MFIs, as an important potential constraint on the future development and sustainability of a microfinance industry. Also, as the sector has matured in many parts of the world, a growing awareness has developed of the Financial Systems approach (explained in Box 1.1), that considers MFIs as players within a *continuum* of financial service providers to address the needs of the population as a whole. This awareness has helped to inspire attempts to harmonize the regulatory and supervisory treatment of MFIs, with that of other types of players in the continuum of financial service providers, and where appropriate, to differentiate the appropriate regulatory and supervisory treatment of MFIs (Lyman 2000, p. 4-6).

3.33 Among many valuable recent contributions on the subject of financial regulation and supervision of MFIs, van Greuning et al. (1999)¹⁴ propose a particularly useful analytical approach to examining these issues. They propose that various conceivable legal forms of MFIs be grouped for purposes of financial regulation and supervision based upon their risk profile, flowing principally from the sources of their lending capital – i.e., the liabilities side of their balance sheets. Fundamentally, the inquiry is into the question whose money is at risk. Three broad categories of MFIs are proposed: i) category A includes MFIs which depend upon “*other peoples’ money*” (in the sense of donated capital or capital from institutional sources); ii) category B includes MFIs which depend on *their members’ money*; and iii) category C includes MFIs that leverage the *general public’s money*. Categories A and C are in turn subdivided, to recognize potentially significant distinctions among different possible types of MFI legal forms.

¹⁴ Much of the discussion that follows is based on Lyman’s (2000, pp. 4-6) elaboration on the analytical framework for regulation and supervision developed in van Greuning et al. (1999).

With respect to each of the different possible types of MFIs identified, van Greuning et al. (1999) then ask: i) is there a need for financial regulation and supervision of this type of MFI; ii) if so, then what are the specific activities or attributes of the type of MFI in question that should trigger financial regulation and supervision; iii) what sort of body is appropriate to regulate and supervise the type of MFI in question; and iv) what are the fundamental issues that must be addressed through the regulatory and supervisory rules applicable to the type of MFI in question? Based on this analysis, van Greuning et al. (1999) summarize their conclusions, as shown in Table 3.2.

Box 3.1: Common Adaptations of Traditional Bank Prudential Regulations and Supervision that Address the Specialized Operations of Most MFIs

- **Lower capital requirements.** Minimum capital requirements should be low enough to attract new entrants into microfinance, but high enough to ensure the creation of a sound financial intermediary.
- **Risk weighting of assets for unsecured loans.** The type of lending (unsecured or secured, and if secured, then by what type of collateral) a bank engages in affects its risk weighting of assets, capital adequacy, and provisioning. Regulators should assess the riskiness of MFIs based on overall portfolio quality and repayment history rather than on the value of traditional guarantees. Historical performance of portfolios, statistical sampling of arrears, the adequacy of MIS, and the MFI's own policies for dealing with arrears should also be taken into account (CGAP 1996).
- **Higher capital adequacy ratios.** A weighted capital adequacy ratio of eight percent of risk-weighted assets is currently recommended by the Basle Accord. Due to their generally lower ability to diversify their risks, MFIs should be subject to even higher capital adequacy ratios as a means to safeguard investor funds. Consideration should be given to application of initial MFI capital adequacy ratios approaching 20 percent with potential lowering to the range of 12-15 percent, based on good performance over time.
- **Stricter provisioning.** Provisioning requirements should be based on the average loan maturity of the portfolio. RMFI portfolios tend to have shorter average maturities, and therefore require more aggressive provisioning. Basle Accord requirements suggest that banks be subject to loan provisioning requirements of 25 percent for sub-standard loans, 50 percent for non-performing loans, and 100 percent for loss loans. Stricter provision loan loss requirements for MFIs should be at least:

10 percent of the unpaid balance	0-30 days in arrears;
25 percent of the unpaid balance	31-90 days in arrears;
50 percent of the unpaid balance	91-180 days in arrears; and
100 percent of the unpaid balance	in arrears more than 180 days.
- **Higher operational costs allowed.** Since MFIs manage small loans and deposits, they tend to have higher operational costs than traditional banks. Allowing MFIs to offer incentive-based payments to staff; to have flexible hours of operation convenient for clients; and to engage in mobile banking, permitting them to disburse funds and collect payments outside branches, can help MFIs to minimize their operational costs. Permitting incentive-based payments to staff assist MFIs reduce portfolio risk. Regulators should not penalize MFIs for higher operating costs if they can demonstrate a reasonable average return on assets.
- **Customized reporting requirements.** Not all the reporting requirements of traditional banks are applicable to MFIs and microentrepreneurs usually cannot produce the same amount of documentation required of traditional lending. Portfolio reporting formats should take into account the volume, loan size, and term of microfinance loans.

Sources: Berenback and Churchill, p. 43

3.34 The prudential theories underlying this analytical framework include the following, among others:

- risks to the financial sector as a whole are greatest where the public's capital might be lost;
- membership-based mechanisms of deposit mobilization are less risky and potentially carry with them their own internal governance controls over risk-taking behavior;

- shareholders' equity may be adequately regulated by general securities regulating bodies;
- comparatively lower levels of risk to the broader financial sector are posed where lending capital is generated from wholesale debt sources; and
- little or no risk to the broader financial sector is posed by the potential loss of donor funds or similarly concessional capital.

Table 3.2: Microfinance Activities and Forms of Regulation¹⁵

<i>Institutional Type</i>	<i>Activity that Triggers Regulation</i>	<i>Proposed Form of External Regulation</i>	<i>Regulatory Agency</i>
Category A: Type 1 Basic non-profit NGO, financed primarily with donor funds and similar forms of concessionary capital	Engaging in the provision of microcredit	None–Voluntary registration with Self-Regulatory Organization (e.g., apex institution, microfinance network, or other self-regulating body to enforce standardized accounting and reporting practices)	None, or Self-Regulatory Organization
Category A: Type 2 Non-profit microcredit NGO with “forced” (mandatory) savings schemes, or other similar approaches, but still relying primarily on donor funds	Limited funds accepted from borrowers to enforce loan repayment (e.g. “forced savings” or mandatory deposit schemes)	None–Exemption or exclusion provision of Banking Law; compulsory registration with Self-Regulatory Organization	Self-Regulatory Organization
Category A: Type 3 NGO transformed into incorporated MFI that accesses equity capital, markets and incurs wholesale debt in addition to donor capital	Issuance of wholesale deposit substitutes (e.g., commercial paper)	Registration as corporate entity; authorization from securities and exchange agency, with limitation on size, term, and tradability of paper	Companies’ registry agency; or securities and exchange agency
Category B: Type 4 Credit Union/Savings and Credit Association (e.g., cooperatives, in WBGS context)	Operation as open-common bond credit union; deposit-taking from member-clients in the community; workplace or trade	Notification to and registration with Bank Supervisory Authority (e.g., PMA)	Bank Supervisory Authority (PMA)
Category C: Type 5 Limited Deposit-Taking institution	Limited deposit-taking from general public. Minor deposits exemption in Banking Law exceeded. Microfinance activities still basic and not on scale of licensed banks. Capital not adequate and therefore asset activities limited.	Registration with Bank Supervisory Authority (PMA) under a limitation provision (e.g., deposits - a smaller multiple of qualifying capital, with high or 100% liquidity reserves in the form of defined banking sector deposits or specified government securities)	Bank Supervisory Authority (specialized unit of PMA dedicated to the regulation and supervision of specialized banking institutions engaging in microfinance operations)
Category C: Type 6 Licensed Mutual Bank, with mutual ownership of shares, accepting public deposits Category C: Type 7 Licensed Equity Bank that accepts public deposits	Non-restricted deposit-taking activities from the general public	Registration as a mutual or equity bank; obtain full or specialized banking license; full or specialized prudential regulation and supervision by Bank Supervisory Authority (PMA)	Bank Supervisory Authority (regular or specialized unit of PMA dedicated to the regulation and supervision of specialized banking institutions engaging in microfinance operations)

¹⁵ Substantially based on van Greuning et al. (1999), p. 3.

3.35 Feasibility of Promoting a New Tier of Regulation for Institutions Engaging in Microfinance Activities. While Massar Associates notes that most NGOs they interviewed expressed a willingness to be licensed and regulated, especially if it enables the NGO to serve as a voluntary deposit-taking institution, most of those NGOs interviewed also hold the view that regulation must come *after* efforts to increase overall public awareness of the availability of microcredit, and how they function as tools for economic growth and poverty reduction. The PMA has also stressed that its major role in this regard is to guarantee the safety of the public savings deposits, therefore any deposit-taking activity, whether administered by a banking institution or through an unlicensed NGO, should be regulated and supervised by them. Currently, the PMA does not envision an increased supervisory role for itself with regard to the activities of microcredit NGOs, except as pertains to the control and recording of cash flows in the country. No enforcement or regulatory legislation pertaining to microfinance activity is under consideration at present, nor planned to be initiated in the near future.

3.36 In addition to licensing banks, part of the PMA Law No. 2 of 1997 (enacted in 1998), provides for the PMA to “License specialized lending institutions and finance companies” (Chapter III, Article 18); as any institution or juridical entity established in Palestine whose main purpose is to give loans for special purposes as determined by the cabinet and is considered by virtue of this law, to be a “Specialized Lending Institution.” Consideration should be given to developing a new tier of financial regulation for financial intermediaries specializing in microfinance operations, including voluntary deposit mobilization from the general public, along the lines described as Type 5, 6, or 7 in Table 3.2 above. This proposed new tier of financial intermediary might be based on the successful experience of introducing such a new tier of regulation in Bolivia (Box 3.2). As a result of the new regulatory framework in Bolivia, several FFPs (private financial funds) have been established and transformed microcredit NGOs, credit unions (savings and loan cooperatives) and commercial banks, and have expanded the provision of microfinance services. Such a new tier of regulation in the WBGS, could be expected to induce progress toward financial self-sustainability of the microcredit NGOs currently active in the WBGS and enhance competition, both of which would serve to enhance the breadth and depth of outreach. The ability of these institutions to mobilize deposits and to obtain deposit insurance, is crucial for their enhanced financial self-sustainability and the development of the microfinance industry in WBGS.

Box 3.2: The Creation of Private Financial Funds (FFPs) in Bolivia

Rationale. Prior to the creation of the FFPs, the microcredit NGOs strongly pressured the SBEF (the Bolivian Superintendency of Banks and Financial Entities) to establish a legal framework that would regulate their operations within the context of the formal financial system. Two main arguments were put forward in justifying the need for “transformation” into a regulated financial entity. First, the most sustainable way for microcredit NGOs to realize the desired levels of expansion was to mobilize public deposits, an activity that was restricted to regulated entities. Second, the ownership structure of an NGO, whose “owners” had no direct economic interests at stake, was thought to be a limiting factor for efficiency, profitability, and sustainability. In short, microfinance operations required a more sustainable ownership and governance structure. Donor agencies, in full support of the NGOs, added two more arguments. First, commercial banks’ low participation in microfinance resulted in part from the lack of an adequate regulatory framework. The establishment of a framework that would count on freely negotiated interest rates, recognize solidarity guarantees and other innovative guarantees as real, and count on an appropriate system for portfolio classification would interest commercial banks in providing services to the sector. Second, capital accumulation through savings accounts was as important as credit for microenterprise growth and family welfare. Microcredit NGOs should be in a legal position to offer this type of service to their clients.

Box 3.2 continued on the next page...

Box 3.2: The Creation of Private Financial Funds (FFPs) in Bolivia Actions, continued

Actions. Supreme Decree No. 24000 of May 1995 authorized and regulated the organization and operations of the FFPs. The decree defines the FFPs as “non-banking financial entities, whose principal objective is channeling resources to micro and small-scale borrowers whose activities are located in urban as well as rural areas” (authors’ translation). The minimum capital requirement for the constitution of a private financial fund amounts to the equivalent in national currency of SDR630,000 (currently the equivalent of about \$1 million). In contrast with commercial banks, FFPs are not legally authorized to offer checking accounts and credit cards or to carry out international trade and trust operations. In addition, and notwithstanding the permissible activities authorized by the law, the SBEF can impose the operating restrictions upon private financial funds that it deems prudent. In short, for each case, the Superintendency determines what a particular private financial fund can or cannot do within the general possibilities established by the law. For example, although the law permits private financial funds to operate savings accounts, in practice the Superintendency must authorize the private financial fund to carry out this type of operation. The authorization depends on an assessment of the private financial fund’s capacity to carry out a particular operation (see also Table 3.3 below).

Results. The single most important result of the Bolivian experience is that, as a result of the new regulatory framework, the formal financial sector is now a major provider of microfinance services. According to FINRURAL’s (a consortium of rural microfinance institutions) statistics as of December 1999, the network of microfinance institutions, including the 13 largest NGOs, BancoSol, and the FFPs, serve 412,164 active clients. The private financial funds and BancoSol serve 217,982, or 53 percent of these clients. Thus, the MSEs are now served through a formal financial system that can offer an array of financial services beyond credit. An important result is that not only the FFPs created by the NGOs (seven in total as of May 31, 2000) and BancoSol serve this sector. Currently, two additional funds created by private investors, ACCESO and FASSIL, are working in microcredit. In addition, five commercial banks have opened microcredit windows. The participation of the banks and the FFPs ACCESO and FASSIL have been primarily oriented toward consumer loans.

Sources: Gomez, Tabaras, and Vogel 2000, Valenzuela and Young, 1999.

Table 3.3: The Microfinance Market in Bolivia

	Banks	FFPs	Credit Unions
Minimum Capital	5,500,000 SDRs	630,000 SDRs	150,000-2,000,000 SDRs
Type of Company	Corporation (Inc.)	Corporation (Inc.)	
Capital/Asset Ratio	10%	10%	10%
Credit Limits	5% without collateral 20% with collateral	1% without collateral 3% with collateral	NA
Legally Permitted Operations	Multiple operations	No checking accounts No credit cards No international trade No trust operations	No checking accounts No credit cards No international trade No trust operations
Legal Cash Reserve	Average: 12%	Average: 12%	Average: 12%
Loan Classification Regulations	Housing Consumption Commercial	Specific for loans below US\$20,000	Housing Consumption Commercial Specific for loans below US\$20,000

Source: Gomez, Tabaras, and Vogel 2000, p. 5.

C. Rules Governing Lending Activity and Collateral

3.37 It is also important to review the legal framework as well as banking regulation and supervision, that govern lending activity and collateral. Lenders need a system wherein claims against property can be created (legally defined), perfected (publicly registered), and enforced. The more uncertain and expensive this process, the less willing may be MFIs to lend (Fleisig and De la Peña 1996). The activities of semi-formal MFIs, like those of the banks, are affected significantly by legal provisions governing the mechanics of lending and loan security. The following discussion outlines Palestinian legal provisions governing lending, collateral and enforcement mechanisms, which are applicable to all entities involved in lending activities, regardless of their legal form. In addition, there are laws governing lending activities and collateral, that fall outside of the body of laws governing banks and other financial services institutions, even if these topics are also covered to some extent in the laws and administrative regulations governing banking and other financial services institutions. These provisions may affect microfinance practitioners, both as lenders and as borrowers. Frequently, some of the most important laws governing lending activities and collateral will be contained in the Civil Code.

i. Loan Documentation, Interest Rates, and Other Loan Terms

3.38 The Civil Code contains provisions relating to loan agreements. However, those provisions do not impose any special documentary requirements on those agreements. Apparently, therefore, loan agreements are subject only to the standard documentation requirements applicable to all contracts. The Civil Code does require that pledge contracts be in writing or notarized, and that mortgages be recorded and their contracts notarized. The Civil Code does not impose any specific caps on interest rates. The PMA may provide guidance and advice as to interest rates and types of credit, but lenders are not legally bound to adhere to the PMA's guidance.

ii. Loan Security and Collateral

3.39 Many types of loan security or collateral are possible under the Palestinian legal system, reflecting the diverse and disjointed system of laws in the WBGS. This section examines moveable collateral, mortgages, intangible property (such as shares in a commercial company or loan portfolios), and various forms of guarantees, with regard to both existing legislation and regulation as well as bills pertaining to such.

a. Movable Collateral

3.40 The Companies Ordinance of 1929, Section 127, authorizes a company to grant the creditor (lender) a mortgage on movable property, including its assets and as soon as this mortgage is registered, it prevents the debtor (company) from disposing of these assets (movables). Although there is no specific chattel mortgage law in the WBGS, in practice, banks with microfinance programs widely engage in the mortgaging of equipment and machinery bought with the proceeds of the microfinance loan, such as the tools used in the professions of carpentry, mechanical repair, blacksmithing and some medical professions. The mortgage is certified through a formal contract registered with a notary public. The documents are well structured and clearly establish the mortgage terms, however, in practice they are not viewed as an effective means of security or enforcement. The tradesman's personal attachment to the asset and his dependence on it as the source of his livelihood, constitutes the real guarantee for the

lender. Under existing laws, certain types of moveable assets and properties can be mortgaged and registered with official registry departments, as outlined below.

3.41 The Jordanian “Road and Transportation Act” No. (49) of 1958¹⁶ and the Mandatory Law of (128) of 1929 and its amendments, provide for the mortgaging of **motor vehicles**, but it only applies in the WB. It enables the transfer of ownership of a motor vehicle or its mortgage subject to the approval of the main vehicle licensing authority. It forbids the transfer of ownership of a mortgaged machine without the consent of the creditor. Such mortgages must be officially registered in the Transport and Licensing Department to be considered valid. This registration will restrict the debtor’s freedom of ownership and no passing of property interest is allowed without the consent of the mortgagee. It is an easy, albeit restricted, device for individuals to obtain cash. It might be of great help for farmers and people using vehicles in their work, such as taxis or deliveries to obtain credit. Banks interviewed by Massar Associates noted that they were using such type of collateral for medium-sized loans, due to its value and official registration.

3.42 The **pledge** is a form of security in which the creditor takes possession of the debtor’s asset as security, until repayment of the debt is achieved.¹⁷ This definition resembles that found in Al Majallah detailed in Articles (701-762). Al Majallah is the Ottoman Civil Code enacted between 1867 and 1877, derived mainly from the Islamic Law (Shari’a) and still applicable in Palestine and many other Arab countries.¹⁸ The pledge in the above mentioned form, does not constitute a widely applicable security interest in modern commercial life. Passing the collateral to the creditor, which might be needed equipment or inventory, will be of little or no assistance to the debtor, who will in most cases require the valued asset in order to carry on with his course of business. Such a pledge will cause him restriction if not prohibition. It might be moderately useful with personal valuable assets such as gold and jewellery. This type of security interest is more common at the individual level, with valuable personal property among women and farmers. It will be only practical if items used or pledged, are not pieces of equipment or other assets required for the conduct of business.

3.43 It is clear from this brief overview of the type of legal mechanisms currently available with respect to movable collateral, that a comprehensive moveable property law should be enacted, based perhaps on the current draft of the Security Interests in Moveable Property Law that has been prepared by the EBRD (European Bank for Reconstruction and Development). It is based on successful secured financing law in provinces of Canada and U.S. The chapter on leasing has been influenced by U.S. leasing legislation and the Convention on International Financing Leasing, prepared by the International Institute for the Unification of Private Law. The chapter on registration, has been influenced by features of the registry systems of Canadian provinces and Norway (Mertz, Robert A., 2001).

3.44 The applications of the draft Security Interests In Movable Property Law include:

- security agreements for movable property;
- lease contracts for movable property; and
- sales contracts for movable property.

In addition to providing for security agreements for a wide variety of movable property, the draft Law contains provisions for leasing, which may also be useful for MSEs. Leasing is analyzed in

¹⁶ Law No. (49) of 1958 issued in the Jordanian Official Gazette

¹⁷ Goode, Roy, Commercial Law, p. 643.

¹⁸ For English translation and explanation of Al Majallah see C. A. Hooper, Civil Law of Palestine and Trans Jordan, Vols. I, II Jerusalem, 1936.

section II.B.v., below. As a necessary complement to this Law, the World Bank financial sector project is proposing to add a Register of Security Interests in Movable Collateral (RIMA). RIMA would be a computerized database of movable assets pledged as collateral for bank loans, that would be the first electronic asset register in the WBGS and which would strengthen the enforcement of lender's property rights.

b. Mortgages¹⁹

3.45 Immovable property in the WBGS, is one of the main types of collateral for pledging security interests. This is because immovable property can be registered formally, it usually has a stable if not increasing value, and the security can be enforced by relatively smooth enforcement procedures in case of default by the borrower. The law regulating pledges over land security in the WB, is the Jordanian Pledge of Immovable Assets as Security for Debt Act No. 46 of 1953.²⁰ While in the GS, the same is regulated by the British Mandatory "Mortgage Law Ordinance" No. 20 of 1920 and No. (9) of 1929.²¹ The laws governing pledges over land are considered to be relatively good ones; the main obstacles for application can be due to the registration of title deeds of plots of land by the name of their owners. Nevertheless the PA have issued a number of decisions in this concern, trying to overcome this obstacle. Decision No. 104 of 1997 has lowered registration renewal fees from six percent to one percent of the value of the land. Prior to this revision, high registration costs were a major deterrent to timely land registration by the owner(s). Decision No. 39 of 1998 extended these lowered fees for another year. Fees for the transfer of mortgages were also lowered to 0.5 percent as well, by virtue of the previous decision, which provided a level of flexibility among creditors. There are still; however, some major legal obstacles regarding these transactions, such as uncompleted settlement procedures and failure to properly register plots. The use of irrevocable powers of attorney as a mean of transfer of title and ownership and its validity for 15 years without registration, has been a major problem as well.

3.46 Despite the relative importance of using immovable property as a security interest, mortgage lending has not become widespread and other, less efficient forms of housing finance have developed. The main type of housing finance available to poorer people, has been construction funded from pooled funds from informal cooperatives. Under this system, a developer builds on a pay-as-you-go basis, based on periodic payments by the future occupants of the new housing. This form of financing, however, is inefficient, since construction costs can increase indiscriminately and there can be substantial hidden costs. If one or more participants are unable to make their periodic payment, the others in the cooperative must make up the difference or face losing their own investments. The partial completion of many such projects, is a common sight in the WB.

3.47 A positive step was taken by the PA towards facilitating the secured transactions, through the enactment of the Condominium Law No. (1) of 1996.²² This Law enables owners to register their own share of land and construction separately. Article Six in this Law indicates the freedom of each owner to dispose, use, and otherwise benefit from the appropriate part that s/he owns. Private owners are now capable to have a pledge over their apartments as subdivisions or individual units and register it in the land registry. However, even after passage of the

¹⁹ This section is heavily based on Mc Gill, Hussein, and Seeger, "Non-Bank Financial Institution (NBFI) Activity: Private Sector Business Growth Opportunities for West Bank/Gaza" presented at the June 11, 2001 Ramallah NBFI Conference.

²⁰ Law No. 46 of 1953, issued in the Jordanian Official Gazette on 1/3/1953, p. 573, Volume 1153.

²² Law No. 1 of 1996, issued in the Palestinian Official Gazette, Volume 41, p. 22.

Condominium Law, subdivision remains relatively rare because, with mortgage financing unavailable, developers have no incentive to subdivide. Publicity surrounding the PMHC's initiation of long-term mortgage financing in September 2000, has resulted in an explosion of subdivisions of incomplete housing developments and applications for registration of ownership of the individual units, in order to satisfy mortgage requirements. McGill et al. (2001, p. 10) note that in Hebron, for example, 70 applications for registration were filed in the first three months of 2001, compared to only seven in 2000. They further note that the subdivision and registration of ownership of individual units after completion and sale of a housing development to numerous occupants, is much more intricate, expensive and time-consuming than before completion. Since, in many cases, such subdivision and registration is practically impossible, many such units are presently not eligible for mortgage financing, and are diminishing in value.

3.48 Development of the mortgage finance sector in the WBGS, appears to rest on dramatically increasing the registration and titling of land and creation of title insurance, in order to make a mortgage a more reliable form of collateral for lenders. McGill et al. (2001) provide an excellent overview of the recent history concerning land registration and titling in the WBGS and related operational issues. Portions of their report form the basis of Boxes 3.3 and 3.4 on these subjects.

Box 3.3: Recent History of Land Registration and Titling in the WBGS

Land registration began when the British assumed control of Palestine in 1914. Jordan continued to encourage land registration when the WB passed to it in 1947. By the time of 1967 Israeli occupation, about 35 percent of land in the WBGS had been registered as a result of large-scale, community-wide registration drives. The process was suspended after the Israeli occupation, and did not resume until 1994, when the PA was given authority over land registration. Progress since then has been slow, due to inadequate funding and staffing, complicated administrative structures, and the complexity of the task.

Full implementation of the land registration system is a long way off. Land registration officials estimate that, assuming adequate funding, it will take up to 10 years to complete the process of surveying all parcels and entering appropriate descriptions in the registry. This is accomplished by a systematic neighborhood-by-neighborhood mapping process that adds to the registry lands that have not been formally entered.

Prior to the completion of the nationwide land mapping, individuals may, for a fee, submit applications for registration in unmapped areas. The applications must establish current ownership and provide a survey description. The registration is considered "temporary" until official mapping of neighboring parcels conclusively establishes parcel boundaries. Even with proper documentation, registration can take from six months to two years, or more. This uncertainty and delay prevents mortgage lending until registration is actually accomplished. Registration is often practically impossible because the chain of ownership cannot be conclusively established. Reasons include a proliferation of heirs over time, missing links in the chain of title caused by immigration of heirs or prior owners, a long line of unregistered transfers extending over decades, and missing documents.

Interviews with lenders and land registration officials evidence that registrars try to be flexible in accepting alternative methods of proving ownership, including proof that the applicant has paid taxes on the subject parcel. However, clear standards are missing, and differing approaches are adopted in different locations. Applicable law recognizes the concept of adverse possession, pursuant to which one openly occupying and utilizing a parcel of land for a specified number of years cannot be divested of possession, even by another with documented proof of ownership, and can freely transfer that right to another. Unfortunately, adverse possession is not a sufficient basis for formally registering ownership, so mortgage financing is not a possibility.

Source: Text for this box is taken directly from McGill et al., 2001, pp. 11-12, with only minor changes.

Box 3.4: Operational Issues Involved in Land Registration and Titling in the WBGS

Land registration in Palestine, instituted during the British mandate, reverses the respective roles of the public and private sectors from the patterns prevailing in the U.S. Recording documents in U.S. land registries merely provides notice to the world of claims to interests in land. The registrar is a functionary who accepts and records – with no substantive review – the deed and mortgage documents submitted by private parties. As a result, the recording process is simple and inexpensive.

Searching and clearing title, however, can be complicated and expensive for private parties in the U.S. Each time an interest is transferred, the buyer or mortgagee bears responsibility for searching the history of the parcel in the land records to determine that no other claimant has an interest superior to the interest to be conveyed by the seller or mortgagor. A large part of the expense arises from the risk of liability incurred by the title searcher, and the cost of title insurance policies intended to guarantee what the search cannot.

The Palestinian system envisions a national land registry in which each parcel is defined by survey in relation to its neighbors, and the fact of registration is conclusive evidence against the world as to the validity of the owner's title. This system reverses the roles of public and private actors from the model prevailing in the U.S. Public registration authorities substantively review the documents submitted for registration to confirm the accuracy of the survey description, and the validity of title from the last registration. Because registration is conclusive evidence of ownership, private parties are entitled to rely on the registration. Once fully implemented, this system reduces the risks, liabilities, and transactional costs of private actors. However, it costs more to support the authorities' substantive screening of documents submitted, resulting in higher registration fees.

Source: Mc Gill et al. 2001, pp. 10-11.

3.49 Several types of interventions might facilitate the use of immovable property as collateral. The development of title insurance could mitigate two challenges to mortgage finance, by providing a bridge that makes immediate lending possible when registrations are delayed by administrative overload and slicing through the difficult legal and historical problems, that make land registration practically impossible in some cases (Mc Gill et al. 2001, p.15).

3.50 The pending restructuring and merger of the three independent departments involved in the land registration process should be completed, to increase efficiency and reduce administrative costs. Consideration should be given to establishing a network of Information and Registration Centers (IRCs). The IRC network would act as a data clearing house for both entry and retrieval of information, thereby aiding property market development. In addition, the Geographic Positioning System (GPS), should be used to more efficiently register title of land in the WBGS. Over the past ten years, GPS has emerged as a major tool for undertaking precise surveys. More recently, it has made inroads in those applications requiring lower precision surveys and is fast becoming a primary technology for acquiring data, for input into geographical and land information systems (GIS/LIS). So-called "sub-meter" GPS receivers can provide coordinates that are sufficiently accurate for cadastral purposes in rural areas. More importantly, these receivers offer an opportunity to significantly lower the cost and time, typically required for cadastral surveys that define, measure, and map land parcels to which registerable land rights are attached.

3.51 In addition to these two interventions that are likely to assist use of land as collateral primarily for commercial lending, other changes (promoted by McGill et al., 2001, p. 17), could potentially enable a greater number of lower-income people to use immovable property as collateral. A legislative solution should be developed to permit registration of cooperative, multi-unit housing developments that have not been properly subdivided. Subdivision and registration

of individual units in multi-unit housing developments should be mandatory, not voluntary. This will permit mortgage financing, and increase the market value of these units.

c. Intangible Collateral

3.52 For completeness, consideration is also given to intangible collateral as a means to secure loans. Although intangible collateral is expected not to be used by microcredit borrowers currently, it should be considered as a potentially useful instrument over the medium to long term. Two types of intangible collateral can be used as the basis for mortgage – company shares and assets. The Jordanian Company Law No. 12 of 1964, makes the mortgaging of company shares possible²³ in the WB. The company is required to be registered, and then this mortgage will be registered at the Companies Registrar in the Ministry of Economy and Trade. For the GS, the British Mandatory Companies Ordinance No. (18) of 1929²⁴, enables the company to give a chattel mortgage over its shares and assets. Chapter 5 of this Ordinance details and gives recognition of such mortgage and requires it to be registered as well, in the Companies Registrar at the Ministry of Justice. This type of security can be applied to simple partnerships, as well as for sophisticated private and public holding companies. In addition, the Trademarks Law No. 33 of 1952 in the WB and Trademarks Law No.(35 of 1938 and its amendments in the GS, have not mentioned such mortgages, but studies show that nothing therein prohibits them.²⁵

d. Guarantees

3.53 At least four forms of guarantees are used widely in the WBGS – personal guarantees, group guarantee with joint liability, bills of exchange and notary deeds. Personal guarantees are commonly used as collateral for loans by banks, microcredit NGOs, and other semi-formal microcredit providers. For example, banks engaging in microcredit provision usually require the submission of a formal form from the client, which is registered at the chamber of commerce or professional bar, and includes tax files and other financial records. Although not formally regulated, group lending with joint liability is utilized by a few semi-formal microcredit institutions, that find it easily enforceable given strong ties in the Palestinian community, especially in urban areas. Some microcredit NGOs interviewed by Massar Associates, noted that they were considering greater use of group lending, but still, many NGOs do not take a positive view of joint-liability approaches to microcredit lending and still request and use formal forms.

3.54 Bills of exchange are considered commercial paper and regulated under Trade Law No. (12) of 1966 in the WB, and in GS by the Cheques and Bills Ordinance No. (47) of 1929, and its amendments. It includes a promise from the debtor to pay the creditor a certain amount on a specified date. It is negotiable, that is it can be transferred to others. Bills of exchange have clear rules and conditions set forth by the regulating law, and can be enforced via the execution department in court, in case of default with no need to file a case. Personal guarantees are often used in combination with this instrument. Usually banks and other microcredit providers have other guarantors signing on this (called *Kumbiala* in Arabic), to assure that they hold someone else responsible for the debt if the debtor does not pay. Usually, when bills of exchange are certified and registered by a notary public, they are more enforceable, since otherwise debtors can claim fraud or forgery to halt enforcement. They can be executed through an application to the

²³ Law No. 12 of 1964 issued on May 5, 1964 in the Jordanian Official Gazette, Volume 1757.

²⁴ Drayton, Compilation of Palestinian Laws, Section 22, Volume 2, 1944.

²⁵ Touqan Tareq, Registering and Licensing Trademarks in Palestine, Master Thesis – University of Birzeit 1999

Execution Department at the court where all judicial decisions and official deeds are executed. The Execution Department then notifies the debtor to pay or otherwise give an objection within five days, or else the execution department will perform an obligatory execution. This obligatory execution will normally mean imprisoning the debtor until s/he pays, or making a seizure on his money in banks and have repayment therefrom, which is usually not applicable for small loans or debtors. In practice, the threat of imprisonment seems to be enough to ensure repayment. There is, however, a major problem in it regarding the number of employees at the Execution Departments, in relation to the workload. There are few people authorized to give notifications to disputants and it may take an inordinate amount of time (in some cases, months), before they are notified.

3.55 A notary deed is prepared and signed by the debtor himself and certified and registered at the notary public, with copy to a creditor. Fees are generally one percent of the total loan amount (although they vary between the WB and the GS), in addition to fees for stamps (that also vary) paid in accordance with the amount, as well. Likewise, bills of exchange and notary deeds are enforced through the Execution Department of the court.

iii. Enforcement Mechanisms

3.56 In the case of loan default, the creditor has the right to implement the conditions and terms of the agreement pertaining to the loan collateral. If enforcement issues arise, the creditor can resort to the judiciary to implement these agreements. Most of our interviewees expressed a clear reluctance of taking judicial action due to cost and time frame, which are inconvenient in general and particularly in microfinance. The actions of the creditor vary depending on the type of collateral, as well for the type of agreement or contract in force. For example, bills of exchange or an official notary deed, can be enforced directly through the execution department; pledges and mortgages require a court order to execute and initiate auction procedures for selling and collecting the debt.

3.57 In general, execution and enforcement restrictions on court decisions in Palestine, have been a major obstacle to increased lending for many years. The problems stem not only from the limitations of legal infrastructure as they exist, but also from a lack of trained personnel, low levels of automation and coordination, and many other logistical constraints. Efforts are underway to computerize court records and legislative activity and to upgrade the skills of appropriate personnel, which should eventually mitigate some of the difficulties currently faced. An Enforcement Law has also been drafted and is discussed below. A particular difficulty is that the enforcement powers of the Palestinian judiciary are restricted in the Jerusalem area, Area C as defined under the Oslo Accords, and over individuals who possess a Jerusalem identity card. These barriers to contractual enforcement decrease the base of microfinance clients. Some banks interviewed by Massar Associates, clearly stated that they do not provide microcredit to Jerusalemites, due to enforcement hindrances in case of default.

3.58 An Enforcement Law has been drafted to alleviate some of these difficulties. The scope of this law is intended to replace a huge sum of British, Jordanian, and Ottoman law currently prevailing in the WBGS. The bill dedicates a separate court annexed to the court of first instance and a special judge and personnel for execution. This may in fact reduce some of the burden courts of first instance are hindered with presently. It reduces mandated time frames for execution and settlement of obligations to seven days in most cases, and to as little as one day in specific types of cases. In Chapter Two, the bill details the execution of official and ordinary deeds as well as commercial papers, with a time frame of seven days as well. The bill also details the

execution procedures regarding liens, especially on movable and immovable property and auction selling. It also details lien terms on shares, deeds, and conveyance.

3.59 The laws regulating bankruptcy and insolvency claims are different for commercial enterprises and civilians. Commercial bankruptcy is regulated in the bankruptcy section of the trade law for merchants; whereas it is regulated under the enforcement law or Execution Law No. (31) of 1952 and “Execution Law Addendum” No. (25) of 1965 for civil lenders. In the GS, the Bankruptcy Ordinance No. (3) of 1936 and its amendments applies to merchants; whereas the Execution Law No. (39) of 1936 prevails for civilians. These laws have regulated matters such as priorities, money, and items on which a formal lien can be placed. Lack of clarity in this body of laws and administrative regulations, certainly makes commercial lending more difficult. Microcredit providers, too, obviously have an interest in clear rules in the case of customer insolvency. However, because the stakes in any specific insolvency-related default on a microfinance loan are likely to be small, problems with bankruptcy and creditors’ rights laws and administrative regulations are perhaps more likely to affect microcredit lenders indirectly, such as by discouraging commercial or other creditors from lending them money.

iv. Rules Governing Leasing²⁶

3.60 Leasing allows MSEs to gain access to short and medium-term capital for fixed assets. Since a lease is made on the basis of an enterprise’s cash flow rather than on its credit history or asset base, leasing gives MSEs with scarce financial resources the opportunity to start a business with only limited funds, or to increase productivity through new capital investment. In an operating, or “true” lease, there is a tax benefit in its application. Modern tax and auditing principles allow the contracting parties to consider it as a virtual sale, although legally it is not. The lessor depreciates the leased object from his assets, while the lessee may deduct the lease payments as a business expense. However, Jordanian Income Tax Law No. (25) of 1964, as well as the Income Tax Ordinance No. (13) of 1947 applied in the GS, does not mention finance leasing, and the Ministry of Finance has not issued any regulations or instructions or adapted any mechanism or methodology to incorporate this concept. Although leasing is currently virtually absent in the WBGS, prospects for leasing as an effective mechanism for rapid mobilization of capital are great, provided the draft Secured Interests in Movable Property Law and Tax Code are passed, the tax treatment of leasing is improved, and greater awareness of the benefits of leasing is spread.

3.61 The Interests in Movable Property Law and the Tax Code, can provide some of the essential infrastructure to support development of a leasing industry, including a registry of property and a clear tax policy, if they are improved from their current draft statuses. In addition, a clear tax policy, perhaps the most important foundation for development of the leasing sector, is currently missing in WBGS. As the Israeli experience demonstrates, all that is required is a short “instruction” for application by taxing authorities. The Minister of Finance appears to have the discretion to issue such an instruction on his own authority. International Accounting Standards (IAS), distinguish between finance leases and operational leases. The economic substance of a finance lease must be recognized for what it is – the purchase of a capital asset. The lessor is really a seller and the lessee a buyer. For tax purposes, the lessor/seller should pay taxes on interest income and capital gains, and the lessee/buyer should depreciate the capital asset over the useful life of the asset. Leasing insurance and a publicly accessible register, can be introduced by private

²⁶ This section is heavily based on Mc Gill, Hussein, and Seeger, “Non-Bank Financial Institution (NBFI) Activity: Private Sector Business Growth Opportunities for West Bank/Gaza” presented at the June 11, 2001 Ramallah NBFI Conference.

sector initiatives. As the industry develops, establishment of an effective regulatory body like the Capital Markets Authority, would be a useful refinement to enforce best practices, standardization of forms, and complete disclosure of all costs.

v. Credit Information Sharing

3.62 Banks currently share information about the credit histories only of their borrowers with loans over \$10,000. This excludes MSE lending and is an impediment to reducing the risks for potential lenders of microcredit and to decreasing the general cost of credit, by not allowing lenders the ability to distinguish the good credit risks from the bad. Establishing a private sector, nationwide credit bureau, would help lenders to accurately evaluate the credit worthiness of prospective clients. In order for the credit bureau to be successful, it will require the support of all banks and credit providers in the WBGS and be designed to include the information most useful to microcredit providers. With the introduction of a credit bureau, other products may be introduced to the market. With access to reliable and timely records on past repayment history and levels of current debt, it is possible to envisage banks offering creditworthy borrowers such products as consumer loans or even credit cards. In this way, the establishment of a credit bureau may enhance both the breadth and quality of outreach, and the transaction costs for both creditors and borrowers will be reduced.

D. MSE Formation and Operation

3.63 A final body of laws and administrative regulations – those governing the businesses of microcredit borrowers – seems often not to get the attention it deserves from microfinance practitioners and policy makers. This tendency is understandable: it is difficult to analyze the legal and regulatory environment for MSEs, without reviewing the entire range of laws and administrative regulations applicable to private business. Nevertheless, the legal and regulatory situation of MSEs does warrant separate consideration in this report, and specific impediments related to the legal and regulatory environment, courts and the judiciary, and access to credit are examined

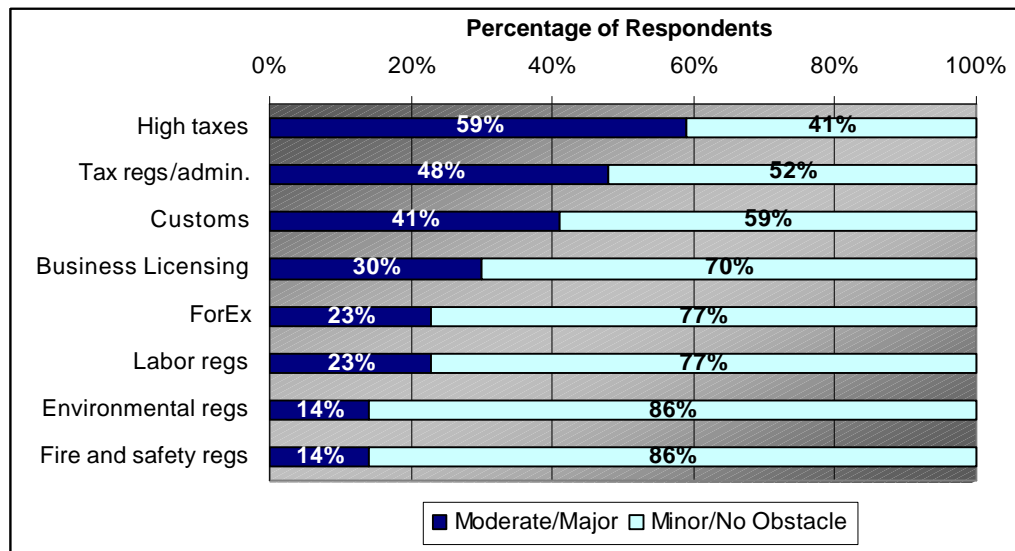
3.64 **Legal and Regulatory Constraints.** The World Bank conducted a governance and business environment survey of 93 small, medium, and large-scale firms in WBGS in mid-2000, as part its larger effort on the World Business Environment Survey. As expected, over three-quarters of respondents to the survey cited political instability and uncertainty as the biggest constraint to their operations and growth. Seventy percent reported their biggest regulatory and administrative burden was the Israeli security procedures (World Bank 2001d, pp. 3 – 4.). Weaknesses in roads and public works services were also a major concern.²⁷ These issues have been addressed previously in this report. The main regulatory and administrative constraints to Palestinian businesses are depicted in Figure 3.3 and discussed below.

3.65 In many developing countries, the legal and regulatory rules for MSEs (and perhaps more importantly, administrative practices) often lag far behind the needs of microentrepreneurs for simple, workable, and inexpensive organizational forms. Often, the relevant rules are too complicated and costly to comply with for many needier microentrepreneurs without substantial assistance. Moreover, even where the relevant rules are relatively clear and the expense of compliance (at least on paper) relatively reasonable, in practice the administering public

²⁷ Fatality rates on WBGS roads are twice those in Israel and five to ten times those in industrialized countries. The fact that there are no controls over vehicle safety in the WBGS, as well as the state of disrepair of the roads, contributes to these higher fatality rates (World Bank 2001d, p. 15)

authorities may find ways to hamper the process significantly and to add illegally to the cost of compliance.

Figure 3.3: Comparative Rating of Regulatory and Administrative Constraints to Business



Source: World Bank 2001d, p. 12.

3.66 Developing countries have taken very different approaches to promoting the private commercial sector. As a result, the different legal and regulatory provisions (and administrative practices) applicable to the registration and operation of legal MSEs, are far too numerous to cover exhaustively. However, some types of provisions that are commonly important to the practical feasibility of registering the MSEs of microcredit borrowers, can nonetheless be identified and can serve as a useful checklist for the WBGS, although detailed analysis of the below was beyond the ability of the author given the short time allocated for this report.

i. Registration Rules

3.67 The threshold legal and regulatory provisions for registered MSEs are obviously those that define the process, by which such businesses are legally formed and registered. Even if fairly straightforward provisions describe the filings that must be made and other steps that must be followed as part of the registration process, microentrepreneurs may be impeded in completing the required formalities by ancillary requirements, such as some of those discussed below.

ii. Business Premises Rules

3.68 Various requirements may exist, as to the availability of “suitable” premises in which to operate the particular type of MSE that is being registered. The securing of suitable premises may even be a prerequisite to business registration. Requirements as to what constitute suitable premises, will likely vary depending upon the type of business activity in question.

iii. Rules Concerning Capitalization and the Maintenance of Accounts in Regulated Financial Institutions

3.69 Minimum capitalization requirements for various types of newly forming businesses, are common. Related to this, microentrepreneurs may be required to open and maintain accounts in a regulated financial institution. These accounts are often tightly controlled and monitored.

iv. Tax and Accounting Rules

3.71 Like MFIs that wish to lend to them, MSEs in the WBGS are subject to an evolving array of taxes and other governmental levies, as well as to frequent changes in the various bases for imposing and collecting them. In addition to staying aware of the various types of taxes, the bases on which they are imposed, and their respective rates, registered MSEs need to have in mind the accounting rules that determine how the various taxes are calculated.

v. Employment Rules

3.72 Along with registration, MSEs are likely to become subject to the provisions of labor and employment law and administrative regulation, making them liable for any employment and social security taxes that fall upon employers under the legal system.

3.73 **Courts and the Judiciary.** The shortcomings of the judicial system in the WBGS are commonly acknowledged, and there is also widespread agreement on what needs to be done to strengthen the legal environment necessary to support MSE development. Investors need assurances that commercial disputes can be resolved fairly and in a timely fashion through the court system, and to attain this goal it is necessary to improve the functioning of the judicial system and the commercial courts in the WBGS.

3.74 The most fundamental issue to be resolved is that the executive and judicial powers need to be separated. Security and military courts weaken the independence and effectiveness of the judiciary and Palestinians may resolve disputes through appeals to security personnel, rather than in civil courts. Presidential ratification of the “Basic Law” (incorporating constitutional provisions) and “the Independence of the Judiciary Law,” passed by the Palestinian Legislative Council (PLC) in 1997 and 1998, would separate executive and judicial powers and increase the powers and capacity of the civil courts to adjudicate commercial disputes. Training of judges needs to be substantially increased and in terms of brick and mortar, adequate facilities in which civil courts can function are also required (World Bank 2001d, p. 17). Conflict resolution mechanisms, including Alternative Dispute Resolution (ADR), are not widely used in the commercial sector; however, a public opinion survey with regard to the value of establishment of ADR centers throughout the WBGS indicates that such centers would be viewed positively and widely utilized.

3.75 The second fundamental issue has to do with the law itself. There is not yet an integrated legal system in the WBGS. The procedures followed in the WB are mainly based on Jordanian law, whereas in the GS, they are rooted largely in common law, dating from the time of British rule. To complicate matters further, East Jerusalem, which is part of the WB, has been subject to Israeli law. Many of the laws affecting the business community in the WBGS are inconsistent with each other, leading to higher transaction costs of doing business and discouraging investment, especially of a longer term horizon (PECDAR, pp. 14 – 15).

3.76 There is, therefore, an urgent need to coordinate the two court systems. The ultimate objective is to unify and expand the current arrangements, in order to construct a transparent legal system capable of providing a firm foundation for economic activity and investment. The Ministry of Justice needs to continue working closely with the Ministry of Economy and Trade

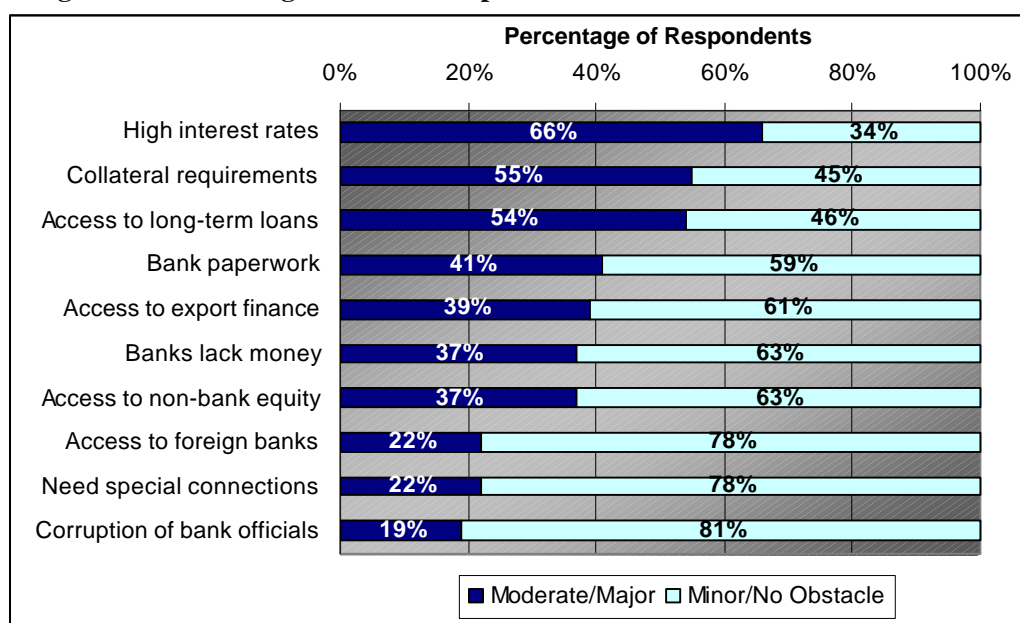
and the Ministry of Industry, to develop laws and regulations supportive of a modern competitive business environment. Among the laws in urgent need of updating and revision are:

- Competition Law and Company law: The WB follows the Jordanian law of 1964, whereas in the GS, the British Mandate laws of 1929 and 1930 are still in force. These laws provide adequate legal registration, but need modifying and unifying.
- Contract Law: There is no comprehensive law governing contracts. This situation discourages economic activities in general and investment in particular, and should be dealt with and remedied as a matter of urgency.
- Commercial Law: Again, with some modifications, the WB follows the Jordanian law. This legislation needs to be elaborated further to provide a healthy environment for business.
- Income Tax Law: A modernization of taxation law is necessary, even though the existing legislation is relatively new.
- Investment Law: Similarly, the investment law needs updating.

3.77 Ownership Law, the Banking Law, and the Secured Lending and Leasing Law, should also be modified and the procedures for company registration and conflict resolution streamlined. World Bank 2001(d) notes other important laws that were also still pending at time of writing, including: Intellectual Property Law, Securities Law (Capital Markets Authority Law), Insurance Law, Provident Funds Law, and Accounting and Auditing Law (World Bank 2001d, p. 17). Obviously, the backlog of pending legislation is quite substantial and all the more pressing to enact, given that some of these Laws have been remaining in various draft forms for five years or more. The Banking Law is a case in point.

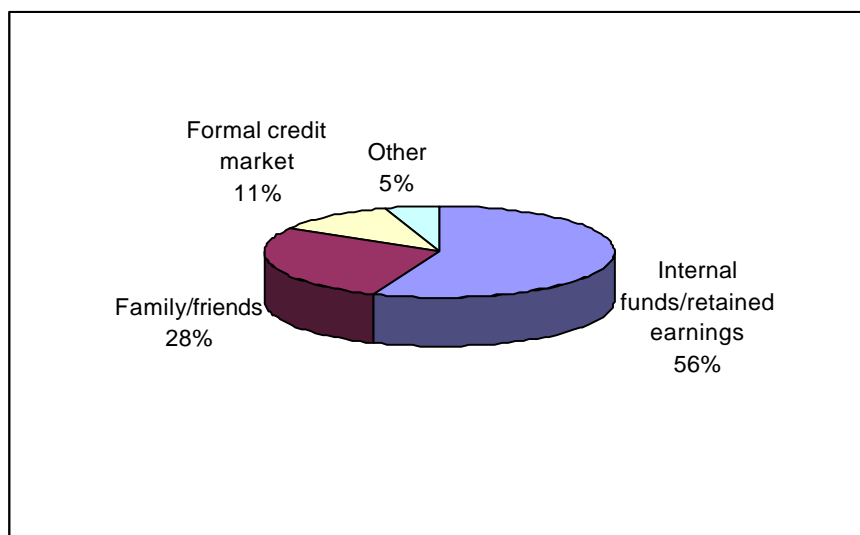
3.78 **Access to Credit.** Financing of business, especially MSEs, is critical to private sector-led growth in the WBGS. Many MSEs are undercapitalized and their low capital-to-labor ratios limit productivity gains. According to the World Bank mid-2000 survey, about half of the respondents considered financing issues to be a moderate to major obstacle to the operation and growth of their business, with high interest rates and tough collateral requirements being the main challenges for small firms (Figures 3.4 and 3.5).

Figure 3.4: Financing Issues in the Operation and Growth of WBGS Businesses



Source: World Bank 2001d, p. 20.

Figure: 3.5: Sources of Credit for WBGS Businesses



Source: World Bank 2001d, p. 21.

3.79 The same survey indicates that formal credit available to WBGS business is limited. Most financing came from internal funds and/or retained earnings, just over a quarter was borrowed from family or friends, and only about 11 percent of credit was available from formal lenders. Findings like these are what provided the impetus for this report. As such, it is hoped that the main findings and recommendations herein provide ample guidance on how to expand access to sustainable sources of formal microcredit to MSEs in the WBGS, as part of general efforts to develop a microfinance industry.

4. THE PALESTINIAN SMALL AND MICRO FINANCE NETWORK

A. Establishment Objectives

4.1 Originally initiated in 1999, the Palestinian Network for Small and Micro Finance (hereafter referred to as the Network) is a voluntary gathering of NGOs, for-profit and non-profit corporations, and banks, conducting special programs for providing microcredit and other financial services targeted to MSEs in Palestine.²⁸ The mission of the Network is “to establish and develop the industry of small and micro sustainable financial services to contribute to the development of small and micro enterprises, through supporting and organizing such service providers in Palestine.” The Network’s objectives are:

- strengthening and consolidating the institutions providing financial services to MSEs;
- creating a conducive legal, regulatory, and supervisory environment, for financially sustainable microfinance providers;
- fostering cooperation between microfinance providers and a sound competitive environment within which to operate; and
- marketing best practices in microfinance provision in Palestine.

4.2 To date, about eight banks and around nine microcredit NGOs and other types of microfinance providers, are actively involved in the initial meetings and registration of the Network. A number of players active in microfinance organizations, including banks, NGOs, and international donors, decided to establish the Network to coordinate their activities in the microfinance sector and to develop and promote the industry in Palestine. The Network has established common ground for future work, and would like to register as a legal entity. In light of the current legal framework and practice in the West Bank and Gaza, registration as an NGO is the only viable and possible legal framework for registration, for the following reasons:

- the Network is an amalgamation and mixture of diverse entities having varied and overlapping interests in microfinance, yet all have a common aim of creating and developing the industry;
- the members of the Network include legal entities that cannot work under the umbrella of a for-profit organization; and
- the WBGS does have legal background and established practices for registering non-profit companies or corporations.²⁹

4.3 Registration of the Network requires submitting an application signed by at least seven members to the (Ministry of Interior) MOI. Intelligence and Preventive Security has the right to grant their security clearance. Other competent ministries may give their recommendations. In the case of the Network, it is probable that the PMA, the Ministry of Information (since the Network might issue publications, and the Ministry of NGOs, may all wish to participate in the Network’s establishment). The Network will be legally registered if attaining the approval of the MOI or

²⁸ This description of the Network is drawn from bylaws drafted in December 2001 as part of its registration process that is yet to be completed.

²⁹ The legal framework in the GS allows for the registering of non-profit companies, but the Ministry of Justice issued a circuit that stopped this practice. In the view of Massar Associates, this circuit does not have enough legal background, but it is issued in order to stop NGOs from registering as companies to avoid the overseeing power of the MOI.

after two months from the date of the last correspondence between the MOI and the Network, without approval.

B. Potential Functions

4.4 Microfinance associations, networks, and support programs have several important roles to play in the continued promotion of sustainable microfinance. They can spread awareness of key features of the financial systems approach to microfinance among policy makers, development agencies, donors, and practitioners. They can also help to integrate microfinance more with the general financial sector and to ensure complementary approaches are considered. In addition, they can collect and disseminate microfinance “best practices”, to accelerate the outreach and financial self-sustainability of their member MFIs, in terms of cost-saving technological developments and creation of linkages to expand outreach, to name but a few topics.

4.5 Depending on the level of interest the members of the Network have in expanding the role of their group and helping to ensure its permanence through financial and in-kind support, there are a number of activities that it may carry out. It would not be necessary to create a large staffing structure, simply a small secretariat office with a manager assisted by an administrator/secretary. Staff could be drawn on a volunteer basis from member organizations as needed for special events/activities.

4.6 Some of the possible activities envisioned in the short-term for the Network include:

- 1) Assist in the identification of local capacity building needs; gather and disseminate information on local adaptation of best practices.
- 2) Coordinate on the delivery of technical assistance and training to MFIs and other stakeholders.
- 3) Assist in the provision of technical assistance or training to MFIs, as capable.
- 4) In consultation with others and its Board, lead the development of standards and ratings for Palestinian MFIs.
- 5) In consultation with others, lead the Palestinian MFIs’ adaptation of standardized accounting and reporting formats.
- 6) Receive member MFI statements and compile the data in order to inform members and other stakeholders on the development of microenterprise services and their socioeconomic impacts.
- 7) Be a contact point to coordinate donor support to the sector and to serve as an interface between the MFIs and relevant government ministries and departments.
- 8) Support relevant enabling legislation important to the development of the ME and MFI sectors.
- 9) Improve on the current ad-hoc system of credit reference reporting initiated by several microcredit NGOs. (i.e., duplicate loans, blacklisted clients, etc.)
- 10) Carry out relevant research and development on issues important to the development of the sector.

4.7 Some of the possible activities envisioned in the medium-term for the Network include:

- 1) Coordinate or conduct sub-sector analyses (i.e., in-depth market research noting growth areas, contractions, etc.)
- 2) If there is sufficient demand for the service, develop linkages with other microfinance networks, such as the MENA regional microfinance networks to carry out training for MFIs and training of trainers.
- 3) Establish linkages between semi-formal microcredit providers and banks.
- 4) Assist the government in developing the appropriate legal and regulatory framework for a private credit bureau to capture the microcredits under \$10,000 borrowed by MEs.
- 5) Conduct or participate in business development service (BDS) surveys and market assessments

5. CONCLUSION

A. Main Findings and Recommendations

5.1 The research conducted for this report was performed quickly relative to the complex and sometimes vague nature of the policies, laws, regulation, and supervision practices relevant to microfinance in the WBS. Despite this, several clear short and medium-term recommendations may be drawn from the main findings. These are grouped below, according to their order of presentation in this report. Main findings and recommendations related to providing an enabling policy environment for the growth of MSEs and the formal and semi-formal MFIs that serve them, are presented first. Second, the relevant legal and regulatory issues are discussed. Third, the (microfinance) Network and its activities are analyzed. This report concludes by noting five topics for future research.

i. The Policy Environment

5.2 Until the peace process leads to a fully autonomous Palestinian government, borrowers and lenders alike will remain wary of unfavorable policies constraining the growth of the microfinance industry. That apprehension is by far the most important factor constraining the development of MFIs, the MSEs they serve, and the general growth of the private sector. It is clear that microfinance is currently not a priority on the short-term policy or legislative agenda of the PA or the PMA. However, government articulation of a cohesive, coherent policy framework for microfinance, developed perhaps in coordination with international donors and the Network, would be a crucial starting point to facilitate development of the microfinance industry.

5.3 Efforts must be directed at reducing the dependence of the Palestinian economy on Israel for the health of the economy, the operations of MSEs, and the MFIs that serve them. This can be done by securing unimpeded access to more distant markets for Palestinian goods by establishing a seaport in the GS and allowing airport operation in both the WB and the GS. Transportation and trade links with Jordan and Egypt need to be strengthened. There is considerable scope for expansion of Palestinian trade with the rest of the World, particularly the European Union (EU) and the U.S. With respect to future trade policy, the IMF and World Bank argue in favor of the PA adopting an open, nondiscriminatory, and transparent trade regime, characterized by the absence of quotas and trade monopolies.

5.4 The Palestinian economy also needs to be integrated by facilitating normal trade relations and movement of people, between and within the territories. Lack of free movement poses a serious impediment to MSE development and growth and dampens their demand for microfinance services. Enabling greater movement would require establishing free passage between the WB and GS, that takes into account Israeli security concerns (for example, by building a service through road) and restoring economic links between the WB and East Jerusalem.

5.5 A well defined policy and legal framework governing land and water resources needs to be established, to provide a more secure base for domestic and foreign investment that can provide greater opportunities for microentrepreneurs and a larger client base for MFIs. Improvements in infrastructure are also needed, especially relating to roads and energy. Further consideration should also be given to developing international free trade zones, especially in the

GS, in order to absorb part of the currently unemployed Palestinian work force and to encourage investment and technology transfer. The Gaza Industrial Estate is a positive step in this direction and it is hoped other industrial estates will be established as well, including in the WB.

5.6 The PA will need to maintain strong budget discipline in 2002 and refrain from non-essential expenditures. In addition, the PA should work with the donor community to express prioritized emergency support to key areas such as budget, basic health and education, job creation, and infrastructure and land rehabilitation. Microfinance should be an integral component of such a support strategy. To assist the PA with its budget shortfalls, Israel should immediately transfer to the PA customs duties and VAT on goods imported through Israel, amounting to approximately \$260 million that was been collected by Israel on behalf of the PA but not paid to it since December 2000.

5.7 Chairman Arafat's failure to delegate responsibility for economic management to appropriate institutions and experts, has damaged those institutions and the possibility for more rapid development. The PA should build up the institutional base of the Palestinian economy so as to create an enabling environment for investment, and provide the underpinnings of growth by harmonizing the judicial systems between the WB and the GS and having a more transparent budgetary process.

5.8 Although the PMA considers its mandatory bank lending ratios as targets only, their existence signals a willingness to intervene directly in the financial markets, which in turn could undermine deposit mobilization, if the general public perceives that these lending pressures might undermine bank performance and stability. This direct government intervention should be removed, as experience worldwide with mandatory lending imposed on banks and other attempts to raise the overall level of lending, such as direct government provision of loans at subsidized interest rates, credit guarantees, and directed credit (to certain industries, state-owned enterprises, or agriculture, for example), have overwhelmingly led to a sub-optimal allocation of resources.

ii. The Legal Framework

5.9 In the WBGS, several formal (e.g., banks) and semi-formal institutions (e.g., NGOs and cooperatives) have been active in providing microfinance, in addition to various informal providers. The relevant laws and regulations currently in effect, establish varyingly stringent requirements that an entity providing financial services must meet, depending on its characteristics and range of activities. Although NGO activities are widespread, they are neither formally regulated nor financially supervised. NGOs are supposed to be supervised by the MOI, or by the relevant ministry as indicated in its registration, but it is widely acknowledged that their supervision is sporadic and weak. According to the Cooperative Law, cooperatives are supposed to be monitored by the Cooperation Department in the Ministry of Labor (MOL), but the MOL's supervision is extremely weak, due to a lack of the necessary manpower and skills. As with the case of NGOs, a shift of regulation and supervisory oversight of cooperatives from the MOL to the PMA, may instill greater confidence in these institutions and allow them to make substantial progress toward increasing their financial self-sustainability and outreach.

5.10 Consideration should be given to developing a new tier of financial regulation for financial intermediaries specializing in microfinance operations, including voluntary deposit mobilization from the general public. This proposed new tier of financial intermediary might be based on the successful experiences of introducing such a new tier of regulation in Bolivia. Such a new tier of regulation in the WBGS, could be expected to induce progress toward financial self-sustainability of the microcredit NGOs currently active in the WBGS and enhance competition,

both of which would serve to enhance the breadth and depth of outreach. The ability of these institutions to mobilize deposits and to obtain deposit insurance, is crucial for their enhanced financial self-sustainability and the development of the microfinance industry in WBGS. Strengthening the supervisory capacity of the PMA would be crucial in this regard. Consideration should be given to developing a specialized unit within the PMA, with responsibility for microfinance operations of regulated institutions.

5.11 A comprehensive moveable property law should be enacted, since there is currently a void regarding legislation and registration of movable assets – often the main type of asset held by lower-income microentrepreneurs. The current draft of the Security Interests in Moveable Property Law that has been prepared by the EBRD, provides a good starting point, as it is based on successful secured financing law in provinces of Canada and U.S. The applications of the draft Security Interests in Movable Property Law include: security agreements for movable property; lease contracts for movable property; and sales contracts for movable property.

5.12 Despite the relative importance of using immovable property as a security interest, mortgage lending has not become widespread and other, less efficient forms of housing finance, have developed. Several measures could overcome this problem. First, the pending restructuring and merger of the three independent departments involved in the land registration process should be completed, to increase efficiency and reduce administrative costs (as proposed in McGill et al., 2001, pp. 10-12). Consideration should also be given to establishing a network of Information and Registration Centers (IRCs). The IRC network would act as a data clearing house, for both entry and retrieval of information, thereby aiding property market development. In addition, the Geographic Positioning System (GPS) should be used to more efficiently register title of land in the WBGS.

5.13 Another recommendation related to increasing the use of immovable assets as accepted collateral, involves the development of title insurance. It could provide a bridge that makes immediate lending possible, when registrations are delayed by administrative overload and it could overcome the difficult legal and historical problems, that make land registration practically impossible in some cases. Based on the findings related to the same recommendation made by McGill et al. (2001, p. 15), PMHC and bank officials have indicated their willingness to accept a properly designed title insurance product. Land registration officials also view it as an opportunity for promoting private sector resolution of title issues and surveys, that will speed the official land registration process. McGill et al. (2001, p. 15) develop a number of options for implementation of a title insurance system, including:

- creation of a new Palestine Land Title Insurance Company, modeled after the mortgage insurance division of the PMHC;
- assisting the PMHC to establish a new title insurance division; and,
- working with existing insurance companies who satisfy minimum capital and other prudential requirements, to develop a title insurance product.

5.14 In addition to these interventions that are likely to assist use of land as collateral, primarily for commercial lending, other changes could potentially enable a greater number of entrepreneurs operating MSEs, to use immovable property as collateral. Despite the enactment of the 1996 Condominium Law, subdivision remains relatively rare because, with mortgage financing unavailable, developers have no incentive to subdivide. A legislative solution should be developed to permit registration of cooperative, multi-unit housing developments, that have not been properly subdivided. Subdivision and registration of individual units in multi-unit housing developments should be mandatory, not voluntary. This will permit mortgage financing, and

increase the market value of these units (these recommendations are also suggested in Mc Gill et al., 2001, p. 17).

5.14 Two other recommendations deserve note from the McGill et al. (2001) report. First, consumer protections must be developed to insure that developers adequately disclose all costs in advance. They rightly suggest revising the draft Capital Markets Authority Law, to explicitly authorize such regulation, would be one way to achieve this goal. Second, persons whose rights in land are established by adverse possession, should be entitled to register ownership. They aptly justify this recommendation, by noting that without this ability, subsequent transfers will be forever unregistrable.

5.15 The McGill et al. (2001) report, also provides excellent recommendations concerning the development of a leasing industry in the WBGS, that is currently absent. Such development would allow MSEs to gain access to short and medium-term capital for fixed assets. Since a lease is made on the basis of an enterprise's cash flow, rather than on its credit history or asset base, leasing gives MSEs with scarce financial resources the opportunity to start a business with only limited funds, or increase productivity through new capital investment. The draft Interests in Movable Property Law and the Tax Code, can provide some of the essential infrastructure to support development of a leasing industry, including a registry of property and a clear tax policy, if they are improved from their current draft statuses. In addition, a clear tax policy, perhaps the most important foundation for development of the leasing sector, is currently missing in WBGS. As the Israeli experience demonstrates, all that is required is a short "instruction" for application by taxing authorities. The Minister of Finance appears to have the discretion to issue such an instruction on his own authority. Leasing insurance and a publicly accessible register, can be introduced by private sector initiatives. As the industry develops, establishment of an effective regulatory body like the Capital Markets Authority, would be a useful refinement to enforce best practices, standardization of forms, and complete disclosure of all costs.

5.16 The shortcomings of the judicial system in the WBGS are commonly acknowledged and there is also widespread agreement on what needs to be done, to strengthen the legal environment necessary to support MSE development and the MFIs that support them. The most fundamental issue to be resolved, is that the executive and judicial powers need to be separated. Security and military courts weaken the independence and effectiveness of the judiciary and Palestinians may resolve disputes through appeals to security personnel, rather than in civil courts. Presidential ratification of the "Basic Law" (incorporating constitutional provisions) and "the Independence of the Judiciary Law," passed by the PLC in 1997 and 1998, would separate executive and judicial powers and increase the powers and capacity of the civil courts to adjudicate commercial disputes. Training of judges needs to be substantially increased and in terms of brick and mortar, adequate facilities in which civil courts can function, are also required (World Bank 2001d, p. 17). Conflict resolution mechanisms, including Alternative Dispute Resolution (ADR), are not widely used in the commercial sector; however, a public opinion survey with regard to the value of establishment of ADR centers throughout the WBGS, indicates that such centers would be viewed positively and widely utilized.

iii. Functions to Consider for the Palestinian Small and Micro Finance Network

5.17 Microfinance associations, networks, and support programs have several important roles to play in the continued promotion of sustainable microfinance. They can spread awareness of key features of the financial systems approach to microfinance among policy makers, development agencies, donors, and practitioners. They can also help to integrate microfinance

more with the general financial sector and to ensure complementary approaches are considered. In addition, they can collect and disseminate microfinance “best practices” to accelerate the outreach and financial self-sustainability of their member MFIs, in terms of cost-saving technological developments and creation of linkages to expand outreach, to name but a few topics.

5.18 One of the most pressing areas in which the Network could support a sustainable microfinance industry, is in the area of assisting with the development of an appropriate legal and regulatory framework for microfinance. Certainly, a hospitable legal and regulatory environment has not proved to be a necessary precondition, to the development of microfinance elsewhere in the world. In general, improvements to laws and administrative regulations affecting Microfinance, have only been undertaken once the microfinance sector has established itself to the point where its contributions could already be offered as empirical support for the proposed changes. The BWGS, however, manifests a number of distinctive features. Among these, two are particularly relevant where legal and regulatory issues are concerned. First, the nascent and evolving nature of the legal and economic systems of the WBGS, presents a challenging combination of “holdover” legal and regulatory provisions, and sometimes hastily (and in some cases, poorly) prepared new laws and administrative regulations. Second, many of the bodies of law and administrative regulation most important to microfinance – the banking law, the law of security interests in moveable assets, the law of enforcement, to name a few - are at this moment in the process of development or substantial overhaul, meaning that the microfinance sector now has the opportunity to advocate a sensible legal and regulatory regime, that may diminish in the near the future.

Other possible activities envisioned in the short-term for the Network include:

- 1) Assist in the identification of local capacity building needs; gather and disseminate information on local adaptation of best practices.
- 2) Coordinate on the delivery of technical assistance and training to MFIs and other stakeholders.
- 3) Assist in the provision of technical assistance or training to MFIs, as capable.
- 4) In consultation with others, lead the Palestinian MFIs’ adaptation of standardized accounting and reporting formats.
- 5) Receive member MFI statements and compile the data in order to inform members and other stakeholders, on the development of microenterprise services and their socioeconomic impacts.
- 6) In consultation with others and its Board, lead the development of standards and ratings for Palestinian MFIs.
- 7) Improve on the current ad-hoc system of credit reference reporting initiated by several microcredit NGOs (i.e., duplicate loans, blacklisted clients, etc.).
- 8) Carry out relevant research and development on issues important to the development of the sector.

5.19 An important medium-term objective of the Network, should be to develop educational programs about microfinance for professionals and consumers. At the university and post-graduate levels, faculties of law, commerce, banking and finance, should include microfinance courses in their current course offerings. Most of them are still following an old classical curriculum that urgently needs updating. In addition, junior and senior lawyers and members of the judiciary should be encouraged to enroll in legal education courses that will introduce and

update their information about the legal background and practical applications of microfinance. Also, bankers and employees of different registry departments, are recommended to attend similar courses in order to gain a deeper understanding of microfinance concepts and procedures. The Network can play an active role in making classes, workshops and seminars available, through a variety of educational outlets and promoting attendance. Microfinance educational programs should also be addressed to businesspersons and consumers, who might one day become microfinance clients. The design of such a consumer education program is beyond the scope of this study, but media campaigns and other traditional means of raising public awareness can be utilized.

Other possible activities envisioned in the medium-term for the Network include:

- 1) Coordinate or conduct sub-sector analyses (i.e., in-depth market research noting growth areas, contractions, etc.)
- 2) If there is sufficient demand for the service, develop linkages with other microfinance networks, such as the MENA regional microfinance networks, to carry out training for MFIs and training of trainers.
- 3) Establish linkages between semi-formal microcredit providers and banks.
- 4) Assist the government in developing the appropriate legal and regulatory framework for a private credit bureau, to capture the microcredits under \$10,000 borrowed by MEs.
- 5) Conduct or participate in business development service (BDS) surveys and market assessments

B. Topics for Future Research

5.20 Several topics not able to be sufficiently covered in this report deserve further analysis. First, a feasibility study should be undertaken to address the net benefits, constraints, and potential remedies, related to the creation of bank subsidiaries to specialize in microfinance. This may be a short to medium-term solution, to the adverse incentives currently in place for Arab and foreign banks that deter them from engaging further in microfinance. Another feasibility study should be conducted to address the establishment of Alternative Dispute Resolution centers. Findings and recommendations from both these studies have the potential to greatly enhance microfinance provision, especially by formal providers.

5.21 In addition, a feasibility study should address the potential establishment of an apex institution, primarily to serve as a funding source for semi-formal microcredit providers. A private facility could be capitalized with public, private, and donor funds, or by any combination of these. Establishing this facility could have a positive, long-run impact, on the development of a microfinance industry in the WBGS. Provided they meet previously determined quantitative and qualitative indicators on outreach, productivity, efficiency, and operational self-sufficiency, microcredit NGOs and other semi-formal microcredit providers could have direct access to funds from this facility. Continued access to funds would be contingent upon satisfying certain reporting requirements and operational targets. Ideally, these funds would be disbursed quickly, be of medium to long-term maturity, and be offered at a cost slightly higher than the average market interest rate paid on savings deposits.

5.22 Also of potential assistance to semi-formal MFIs, a feasibility study should be conducted to analyze the issues involved in creating a private, nationwide credit bureau. This would involve a thorough review and analysis of existing Palestinian law, to see if new and enabling legislation

would be needed to allow for the creation of a private credit bureau and the sharing of consumer credit information, between companies that currently store this info (similar to the U.S. Fair Credit Reporting Act that was originally passed by the US Congress in 1973 and amended in 1997 as well as the recent Jordanian legislation patterned off of it).

5.23 Finally, for benefit mainly to the MSEs , a review should be undertaken to analyze the various legal and regulatory provisions (and administrative practices), applicable to the registration and operation of legal MSEs. Such an analysis would take into consideration at least the following common problem areas: registration rules; business premises rules; rules concerning capitalization and the maintenance of accounts in regulated financial institutions; tax and accounting rules, and employment rules. Such a study has the potential to uncover current areas of difficulty (that may lead to depressed demand for microfinance) and to propose business-friendly solutions, that could improve several relevant pending laws both for the benefit of MSEs and the MFIs that serve them.

BIBLIOGRAPHY

- Alonso-Gamo, Patricia; Max Alier; Thomas Baunsgaard; and Ulric Erickson von Allmen. 1999.** West Bank and Gaza Strip: Economic Developments in the Five Years Since Oslo. International Monetary Fund: Washington, D.C.
- Barnett, Steven; Nur Calika; Dale Chua; Oussama Kanaan; and Milan Zavadjil. 1998.** The Economy of the West Bank and Gaza Strip: Recent Experience, Prospects, and Challenges to Private Sector Development. International Monetary Fund: Washington, D.C.
- Charitonenko, Stephanie and Jacob Yaron, December 2000.** Review of Bank Rural Finance Lending: Projects Approved FY94 – FY99, Mimeo. World Bank: Washington, D.C.
- Middle East Strategy Group. 1996.** Recommendations on the Palestinian Economy: Report of the Middle East Economic Strategy Group. U.S./Middle East Project of the Council on Foreign Relations, November 12, 1996.
- Hamed, Osama; Samia Al-Botmeh; and Fause Ersheid. August 1998.** Informal Finance and Lending NGOs in the West Bank and Gaza Strip. Palestine Economic Policy Research Institute.
- Husseini, Hiba. 2000.** Bank Lending Practices in Palestine. Center for Palestine Research and Studies.
- FATEN, October 2001,** A Microfinance Program Under War Situation: Quarterly Report July – September 2001. FATEN.
- Lyman, Timothy R., 2000.** A Diagnostic Kit for Analyzing the Legal and Regulatory Environment for Microfinance in the Regional Study Report: The Legal and Regulatory Environment for Microfinance in Central and Eastern Europe and Central Asia, ECSSD, World Bank.
- Mc Gill, Olin; Hiba Hussein; and Charles Seeger. 2001.** Non-Bank Financial Institution Activity: Private Sector Business Growth Opportunities for West Bank/Gaza. Prepared for the June 11, 2001 Ramallah Non-Bank Financial Institutions Conference by Financial Markets International, Inc.
- Mertz, Robert A., 2002.** Structure of The Interests In Movable Property Draft Law of 2000. World Bank, Washington, DC.
- Otero, Maria and Elisabeth Rhyne, eds. 1994.** The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor. Kumarian Press: West Hartford, Connecticut.
- PECDAR. 2001.** Palestine: Building the Foundations for Economic Growth, www.pecdar.org/default2.asp?tree=2083.

- PMA. 2000.** Palestine Monetary Authority: Establishment,
www.pma.gov.ps/establish/establish.htm.
- UNRWA. 2000.** Future Prospects for the Income Generation Programme: A Policy Option for UNRWA.
- USAID. 2001a.** Economic Growth Activities
http://www.usaid.gov/wbg/program_economic_activities.htm
- USAID. 2001b.** Annual Program Statement (APS) Emergency Financial Services for Palestinians. June 28, 2001
- Valdivieso, Rosa A.; Ulric Erickson von Allmen; Geoffrey J. Bannister; Hamid R. Davoodi; Felix Fischer; Eva Jenker; Mona Said. 2001.** West Bank and Gaza: Economic Performance, Prospects, and Policies. International Monetary Fund: Washington, D.C.
- Von Pischke, J.D. 1988.** The Financial Systems Approach to Development Finance and Reflections on its Implementation. Johns Hopkins University Press: Baltimore, MD.
- Weidemann Associates. 1999.** Assessment Report of the Demand for Microenterprise Finance and Demand Elasticity Factors in the West Bank and Gaza. Prepared for USAID/West Bank and Gaza by Lucy Creevey, James Hairston, and Mazen As'ad. Weidemann Associates: Arlington, VA.
- World Bank 2000.** World Bank Country Brief for the WBGS (August 2000).
- World Bank 2001a.** One Year of Intifada, November 2001. World Bank West Bank and Gaza Office: Jerusalem.
- World Bank 2001b.** Poverty in the West Bank and Gaza, June 18, 2001. Middle East and North Africa Region, the World Bank.
- World Bank 2001c.** West Bank and Gaza at a Glance, September 17, 2001. World Bank
- World Bank 2001d.** Governance and Business Environment in West Bank/Gaza. May 2001. Office of the Chief Economist, World Bank.
- Yaron, Jacob; MacDonald Benjamin; and Gerda Piprek. 1997.** Rural Finance: Issues, Design, and Best Practices. Environmentally and Socially Sustainable Development Studies and Monograph Series, No. 14. World Bank: Washington, D.C.

ANNEX 1: SCOPE OF WORK (SOW)

Chemonics International ISAMI Project Scope of Work Short-Term Expatriate

BACKGROUND

Through the FS IQC Task Order #802, “Building a Microfinance Industry in the West Bank and Gaza” (ISAMI Project), USAID/WBG is supporting a program of technical assistance and training to banks and non-profit organizations to develop a sustainable microfinance industry in the West Bank and Gaza (WBG), targeting its Strategic Objective #1, “expanded private sector economic opportunities.” About 90 percent of companies in WBG employ five people or less, however, only one in four of these microenterprises has access to loans from the formal banking system; preventing most of these companies from expanding. In order to expand existing microenterprises and promote general private sector development, more formal microfinance services need to be made available to a greater number of micro and small-scale enterprises. Chemonics International and its partners are implementing the ISAMI project to enhance the potential for rapid growth of the microfinance industry in WBG and to make it a sustainable feature in the region.

PURPOSE OF ASSIGNMENT

A study on the policy environment and on the evolving legal and regulatory framework with direct relevance to the following components: developing a microfinance association, raising public awareness about microfinance; creating linkages within the microfinance sector; establishing a credit bureau useful to microfinance institutions; and enabling the provision of financial services on a commercially-viable basis. This study, building on USAID/WBG’s technical assistance to the Palestine Monetary Authority (PMA), will specify constraints inhibiting the development of a microfinance industry and propose policy, legal, and regulatory improvements to create an enabling environment for microfinance.

Findings of the study are expected to be forward-looking and specific. Recommendations will include means to mitigate the constraints to expansion of unsecured lending. In addition, they will address changes to overcome obstacles in loan collection.

In analyzing the legal and regulatory framework, the study will place special attention on the feasibility of promoting “specialized microfinance banks” in WBG, an approach that Bolivia, Indonesia, and the Philippines have embraced with impressive success. The study will elaborate on how these entities should be entitled to mobilize voluntary deposits subject to regulation and supervision adapted to their specialized operations.

TERMS OF REFERENCE

The Consultant will travel to WBG to supplement and finalize the draft report, “Review of Policy, Legal, and Regulatory Environment of Microfinance in Palestine.” The final version of the report will incorporate the following:

- Specific analysis of macroeconomic and financial sector policies that affect microfinance and recommendations on how to improve the policy environment for microfinance.
- Detailed assessment of the legal environment and the banking regulation and supervision practices relevant for microfinance with suggestions on changes in these to create a more appropriate and efficient legal and regulatory framework for microfinance.

ANNEX 1: SCOPE OF WORK (SOW)

Continued

- Findings from discussions with relevant development partners (for example, the World Bank and KPMG Barents) on how efforts to improve the policy, legal, and regulatory environment for microfinance can be coordinated.
- Recommendations on what “value-added” a microfinance association could bring toward creating a policy, legal, and regulatory framework conducive to growth of the microfinance industry.
- An action plan outlining practical, realistic short-term and medium-term steps that could be taken to help develop and promote microfinance markets in the WBG.

DELIVERABLES

Final version of the report, “Review of Policy, Legal, and Regulatory Environment for Microfinance in Palestine.”

QUALIFICATIONS

MBA/MA in business, finance, international development, or related field; minimum of 10 years microfinance experience; knowledge of the policies, laws, and regulations affecting microfinance; strong analytical skills; and computer proficiency.

LEVEL-OF-EFFORT

15 days of level-of-effort, including 3 days of travel are required for this SOW.

TIMING

Fieldwork will be undertaken December 3 – 14, 2001 and the report will be finalized/submitted to USAID/WBG by December 31, 2001.

ANNEX 2: LIST OF PERSONS CONSULTED

Firas Al-Najjab, Arab Bank, Jerusalem.

Khalal Asara, Capital Market Attorney, FMI, Ramallah.

Frank E. Blimling, Senior Advisor, Barents Group, KPMG Consulting, Jerusalem.

Olivier Boudart, Food Security Program, EU, Jerusalem.

Youssef I. Habesch, Investment Officer, Central Asia, Middle East, and North Africa, IFC, Jerusalem.

Lubna Katbeh, MASSAR Associates, Ramallah.

Mohammad Khaled, Executive Director, FATEN, Ramallah.

Rami B. Khoury, Investment Officer, West Bank and Gaza Field Office, IFC, Jerusalem.

Olin McGill, Capital Market Attorney, FMI, Ramallah.

Robert A. Mertz, Principal Financial Analyst, Infrastructure Development Group, MENA, World Bank, Jerusalem.

Joseph Nesnas, Arab Bank, Jerusalem.

Johnny S. Zeidan, Private Sector Specialist, USAID/WBG, Tel Aviv.